

# Litigation & Valuation REPORT

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## Profit vs. Costs

Estimating Avoided Costs Is  
Critical To Lost Profits Calculation

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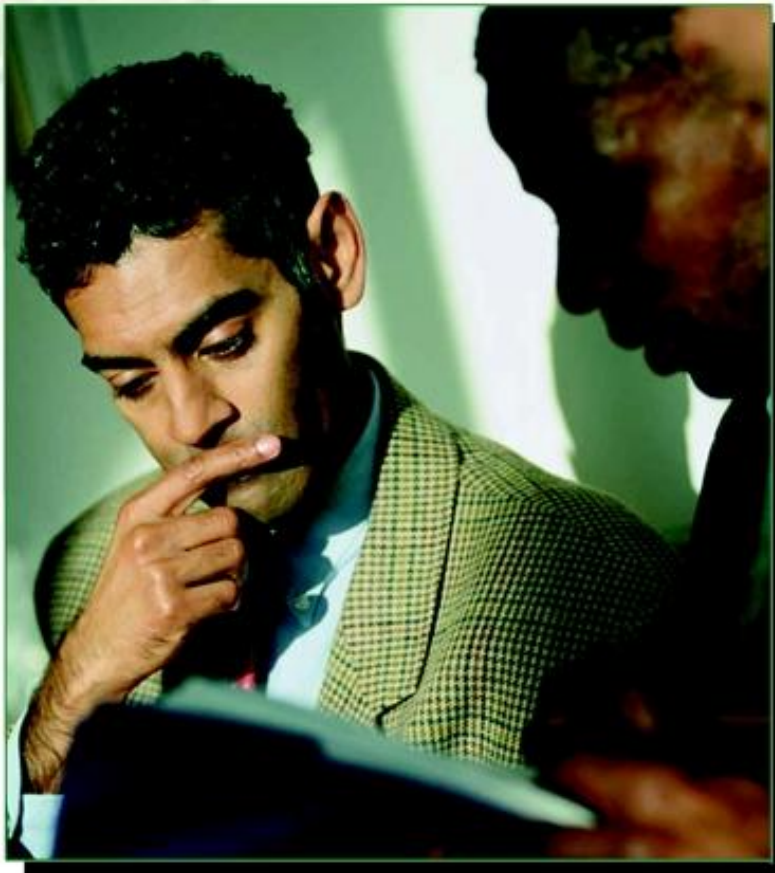
# Profits Vs. Costs

## Estimating Avoided Costs Is Critical To Lost Profits Calculation

In many types of business litigation, plaintiffs seek to recover the profits they would have earned “but for” the defendant’s wrongful conduct. It’s important to recognize, however, that lost profits do not equal lost sales. When a business loses sales, it also avoids certain costs — such as raw materials and labor — that it would have incurred in making those sales. In some cases, therefore, lost profits is the difference between lost sales and avoided costs. Financial experts estimate costs by analyzing historical information and applying professional judgment or analytical techniques. They may rely on cost information contained in a company’s accounting systems, financial statements or other reports. If this information is unavailable or unreliable, they may gather statistical data from industry or government sources.

### Types of Costs

At first blush, calculating avoided costs may seem like a simple proposition: Take the company’s total costs and divide them by the total number of units produced to arrive at the cost-per-unit. If the plaintiff’s cost-per-unit is \$1 and it loses 50,000 sales, it would seem that its avoided cost is \$50,000. But this oversimplified approach understates the plaintiff’s lost profits. Why? It fails to take into account the different types of costs. Costs may be broken down into direct costs and indirect costs. Direct costs, such as raw materials and direct labor, are directly related to the production of a specific product and almost always vary proportionately with the volume of production. Indirect costs, such as overhead and indirect labor, may be fixed or variable. Fixed costs, such as rent, are the same regardless of the level of production (at least within a certain range). Variable costs, such as shipping expenses, depend on production levels.



In most cases, to obtain an accurate picture of a plaintiff’s lost profits, the valuator takes lost sales and subtracts the *incremental* cost of producing those sales. The incremental cost generally includes direct costs plus indirect costs that vary with the volume of production, both of which are avoided when sales are lost. But because the plaintiff continues to incur fixed costs despite the lost sales, subtracting those costs distorts the plaintiff’s lost profits. That’s why calculating the cost-per-unit based on the company’s total cost, as in the example above, leads to unfair results.

### Cost Estimation Methods

Methods for estimating costs include:

**Direct cost assignment.** This is a simple method that can be effective in the

appropriate circumstances, such as a dispute over the cost of a specific product. The financial expert analyzes costs directly related to a product, such as materials and direct labor (often obtained from invoices or financial statements). The analysis may require adjustments if material prices have changed or if the company uses inventory accounting methods, such as last-in first-out (LIFO), that cause reported costs to differ from actual incremental costs.

**Account analysis.** The financial expert reviews various expense categories in the general ledger to determine which costs are fixed and which are variable. Variable costs are usually added together and divided by total revenues (or some other factor, such as direct labor costs) to obtain the variable cost per unit

One drawback to this approach is that it doesn't distinguish semi variable costs — the expert must use his or her professional judgment to classify such costs. Because this introduces an element of subjectivity, the results should be confirmed using another approach.

**Ratio analysis.** Using ratio analysis, a financial expert studies relationships between specified costs and some measure of production, such as units sold, dollars of sales or direct labor hours. Total overhead costs might be divided by total direct labor hours, for example, to arrive at overhead costs per direct labor hour. But this approach may not be appropriate under all circumstances, such as when marginal or incremental costs are at issue.

*Experts estimate costs by analyzing historical information and applying professional judgment or analytical techniques.*

**Regression analysis.** An expert using regression analysis examines historic cost relationships and reduces them to an algebraic line formula. After plotting the observed costs, the valuator mathematically determines a line

## Fixed vs. Variable

Disputes in lost profits cases usually revolve around the classification of costs as fixed or variable. This requires an element of subjective, professional judgment, because the line between fixed and variable isn't always clear. The valuator's analysis depends in part on the time frame involved. If the time period is long enough, all costs vary. Conversely, if the time period is short enough, most costs remain fixed.

Complicating matters further, many costs are semi variable (sometimes referred to as "semi fixed"). These costs remain fixed within a certain range of production volumes, but increase when volume reaches specific levels. Administrative salaries are a good example. A company may be able to operate effectively with two administrative people, but when volume reaches 100,000 units, a third person may be necessary to handle the workload. In a sense, all fixed costs are semi variable given a sufficient time period, and the financial expert needs to take this into account.

that represents estimated costs at various levels of production. By examining this information, the expert can estimate the avoided overhead costs associated with lost sales. Although this method is complex, the valuator can often show the cost relationships on a graph that judges and juries can easily grasp.

To obtain greater confidence in any cost estimate, a financial expert can use multiple methodologies and compare the results to historical data, independent estimates or industry statistics.

## Consider the Cost

Many factors affect the computation of avoided costs — this article only scratches the surface. But it's important to understand the impact of costs on lost profits damages and how the cost calculation is affected by the nature of the litigation, the volume of lost sales and the relevant time frame. ♦

# FLPs continue to be viable

## Recent developments in family limited partnerships

**S**ince 1993, when the IRS began allowing minority interest valuation discounts for interfamily transfers, the family limited partnership (FLP) has been a popular and effective tool for managing and transferring family wealth.



Despite a series of successful IRS challenges in cases like *Estate of Strangi*, there's no reason to doubt the FLP's continued viability as a planning strategy. On the contrary, most of these cases involved FLPs that were structured or operated carelessly. And the courts' explanations of where the taxpayers went wrong provide a roadmap for doing it right.

### Strangi But True

Under Internal Revenue Code Section 2036(a), transferred property can be brought back into a decedent's estate if he or she retained either:

1. The possession or enjoyment of, or the right to the income from, the property, or
2. The right, either alone or in conjunction with any person, to designate who will enjoy the property or its income.

But the rule doesn't apply if the transfer is a bona fide sale for adequate and full consideration.

In *Estate of Strangi v. Commissioner* — also known as *Strangi II* — the Tax Court held that the Strangi family's FLP should be disregarded for estate tax purposes under Sec. 2036(a). The court found an implied agreement that Mr. Strangi would retain possession or enjoyment of the assets he transferred to the FLP. Thus, the bona fide sale exception didn't apply.

### Wrong Turns

The Fifth Circuit's 2005 decision in *Estate of Strangi v. Commissioner (Strangi III)* affirmed the Tax Court's decision.

Although this decision was a blow for the Strangi estate, it isn't necessarily bad news for other taxpayers. That's because the Strangi family made a number of critical mistakes in structuring and operating their FLP — mistakes that other taxpayers can learn from and avoid. Although the Strangi family had created a legitimate FLP on paper, several facts led the Tax Court and the Fifth Circuit to conclude that the agreement implied that Mr. Strangi would retain possession or enjoyment of his wealth, including the following:

- Mr. Strangi was practically on his deathbed when he transferred virtually everything he owned, including his home, to the FLP in exchange for a 99% limited partnership interest.
- The remaining 1% was owned by a corporate general partner in which Mr. Strangi had a 47% interest. Mr. Strangi's four children purchased the other 53% of the corporation's stock. The corporate general partner was managed by Mr. Strangi's son-in-law, whom he had previously appointed as his attorney-in-fact.
- Mr. Strangi did not retain sufficient liquid assets to meet his living expenses.
- Both before and after his death, the FLP made a number of distributions to Mr. Strangi to meet his needs and expenses, including \$40,000 to pay funeral and estate administration expenses and more than \$3 million to pay estate and inheritance taxes.
- Mr. Strangi continued to live in the home he had transferred to the FLP. Although the FLP accrued rent on its books, the rent wasn't actually paid until more than two years after Mr. Strangi died.
- The Strangi family didn't operate the FLP as a legitimate business. It never made any investments or conducted any active business after it was formed.

“Given these circumstances,” the Fifth Circuit concluded, “we cannot say that the Tax Court clearly erred in holding that Strangi and his children had some implicit understanding by which Strangi would continue to use his assets as needed, and therefore retain ‘possession or enjoyment’ within the meaning of Sec. 2036(a)(1).”

The court also found that the transfer to the FLP did not meet the bona fide sale exception, which requires a “substantial nontax purpose.” Although the estate offered several nontax rationales for Strangi’s transfer of assets to the FLP, the facts did not support any of them.

### Lessons Learned

Taxpayers and their advisors should view *Strangi III* not as an obstacle to using FLPs, but as a guide to structuring and operating an FLP that will withstand an IRS challenge. Lessons to be learned from *Strangi III* include the following:

- ✦ If possible, the transferor should establish the FLP while in good health.
- ✦ All legal formalities should be observed in forming and operating the FLP, including transferring legal title to all property to the FLP and keeping proper books and records.

- ✦ The transferor should retain sufficient assets outside the FLP to pay his or her living expenses
- ✦ If the transferor continues to use a home or other transferred property, he or she should pay fair market rent to the FLP.
- ✦ Any distributions the FLP makes should be on a pro-rata basis. It is preferable for the partnership to pay periodic cash distributions if liquidity is sufficient.
- ✦ The FLP should have one or more valid, documented nontax business purposes and actively manage its assets.
- ✦ The transferor and other partners should receive adequate value in exchange for any assets they contribute to the FLP.
- ✦ The transferor should not retain the right to designate who will possess or enjoy the FLP’s assets.
- ✦ None of the partners should commingle personal assets with partnership assets or convert any partnership assets to their personal use (other than scheduled pro-rata distributions).

Encourage your clients with FLPs to review and, if necessary, update their estate plans in light of the guidance provided by *Strangi III*.

## Valuing Retirement Plans In Divorce

In marital dissolution cases, retirement plans are often among the largest assets to be divided. When a couple has been married a long time or when a spouse has participated in a retirement plan for many years, these benefits can easily make up more than half of the marital estate.

In some cases, retirement benefits are divided between the spouses using a Qualified Domestic Relations Order (QDRO). In others, a spouse retains the rights to his or her benefits in exchange for surrendering other marital assets. Under either approach, an accurate valuation of the retirement plan benefits is essential to help achieve an equitable property settlement.

### Valuation Challenges

Valuing retirement plans can be challenging because the valuator must compute the present value of expected future benefit payments. The process is complicated further by the need to determine the marital and non-marital portions of the benefits and to address vesting schedules, life expectancies and other uncertainties.

Here’s an overview of some, but certainly not all, of the valuation issues that can arise.

### Defined Contribution Plans

Defined contribution plans — such as 401(k) plans and profit-sharing plans — are usually the simplest to value.

That's because the present value of the benefits at any given time is generally equal to the participant's vested account balance.

If the participating spouse joined the plan during marriage, a formal valuation may not be necessary. If the account predates the marriage, however, a valuator will need to determine the marital and non-marital portions of the account. In most states (including many community property states), premarital contributions — and earnings attributable to those contributions — are excluded from the marital estate.

To calculate the marital and non-marital portions of the retirement account, the valuator scrutinizes account statements from the date of marriage through the valuation date. The valuator may determine the marital portion by taking all contributions during the marriage and computing the investment gains and losses attributable to those contributions through the valuation date.

An alternative, and often simpler, approach is to start with the account balance on the date of marriage and add investment gains and losses on that amount through the valuation date. The valuator subtracts that figure from the total account balance on the valuation date to arrive at the marital portion of the account.

### Vested Vs. Unvested Benefits

When handling retirement benefits that aren't fully vested at the time of divorce, a valuator typically employs one of two basic approaches. The first is to adjust the present value to reflect the probability that the unvested benefits won't be received. The disadvantage of this approach is that, if the participant never becomes fully vested, the benefits will have been overvalued. The other approach is to value only the vested benefits and use a qualified domestic relations order (QDRO) to divide the unvested benefits between the spouses. This protects the participant from potentially harsh results in the event those benefits never vest.



### Defined Benefit Plans

Defined benefit plans make retirement payments out of a general pension fund rather than individual participant accounts. At any given time, a participant's accrued monthly benefit is determined by a formula based on years of service, earnings history and other factors.

Typically, when valuing pension benefits in connection with a divorce, the valuator begins with the accrued benefit on the valuation date. It's generally inappropriate to use the participant's projected benefit at retirement because it reflects benefits earned after the marriage.

The valuator charts a monthly income stream beginning on the expected retirement date and uses actuarial or economic valuation techniques to convert the income stream into a lump-sum value on the retirement date. That value is then brought back to a present value on the valuation date. The valuator may also discount the present value to reflect the probability that the participant will survive until retirement.

### Valuation Has Its Benefits

When retirement plans make up a significant portion of a divorcing couple's wealth, the first step toward equitable settlement is to conduct a valuation of the retirement benefits. Valuing retirement benefits can be complex, especially when defined benefit plans are involved, so it's important to retain the services of an experienced valuation professional.

## How Much Should Valuation Discounts For Fractional Real Estate Interests Be?

Valuing undivided fractional interests in real estate, such as tenancy-in-common interests, presents a number of interesting valuation challenges. Valuers generally agree, for example, that the value should be discounted to reflect lack of control and marketability, but the amount of the discount is often subject to debate.

### The Partitioning Issue

It's important for the business valuator to review any discounts the real estate appraiser has already considered. Fractional interests in real estate behave differently than, say, limited partnership interests. Tenants in common all have an equal voice in the management of the property, regardless of the relative sizes of their interests. And any tenant can sue to partition the property or force a sale.

The IRS has often taken the position that discounts for fractional interests in real estate should be limited to the tenant's pro-rated share of the estimated cost of partitioning the property. The right of partition, the IRS reasons, creates liquidity and eliminates concerns about lack of control and marketability.

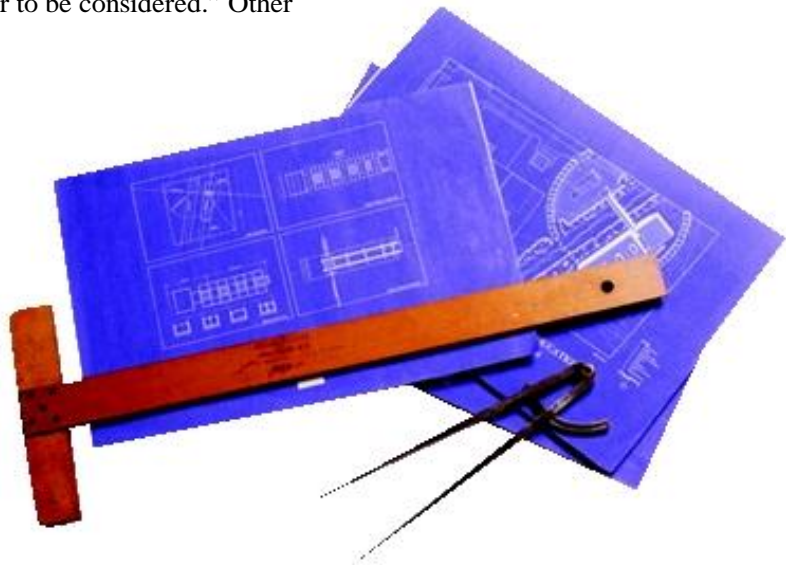
The Tax Court has generally dismissed this approach as overly simplistic. For one thing, it ignores the fact that partition may not be a viable option. A court-ordered partition or forced sale can diminish the property's value.

### Case In Point

In Estate of Baird, the Tax Court allowed a 60% discount for an undivided fractional interest in Louisiana timberland. The court rejected the IRS's argument that the discount should be limited to the estimated cost of a hypothetical partition, which was approximately 3%.

"The cost of partition," the court explained, "does not set some absolute limit on the amount of discount. Instead, it is a factor to be considered." Other relevant factors in Baird included:

- The total number of owners,
- The "staying power" of existing owners,
- The percentage available for sale,
- The property's location, size, topography and number of tracts,
- Continuity of the tracts,
- Access to the property,
- A buyer's ability to influence management, and
- Mineral values.



### Importance Of Evidence

Recently, the Fifth Circuit Court of Appeals held that the IRS's position in Baird was unjustified and that the taxpayers were entitled to recover their administrative and litigation costs. The Fifth Circuit's decision underscores the importance of supporting valuation discounts with solid, well-documented evidence.