



The Expert

Perspectives **L** on Litigation Services

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Valuing professional practice shares: Why buy-sell agreements don't rule

When valuing a partner's share in a professional practice — whether in a divorce or taxation context — the practice's buy-sell agreement can't be relied upon to reflect fair market value.

A buy-sell agreement provides for payment to a professional for his or her shares upon departure from the practice rather than providing that buy-in or buy-out prices be determined according to fair market value. It may specify an amount or incorporate a formula that will probably produce a nominal value. Buy-sell agreements alone can understate the practice's actual buy-in or buy-out price, so a valuation must examine the surrounding circumstances, in addition to the stated price.

Sidestepping fair market value

Buy-sell agreements often rely on one of the following formulas:

Accrual-basis-accounting book value. Under this approach, the price is based on the share's book value (BV) according to generally accepted accounting principles (GAAP). To reach the BV a practice's liabilities are deducted from its assets. The formula includes accounts receivable, accounts payable and other accrued liabilities. Assets are recorded at their original cost and depreciated over time.

Valuations of professional practice shares should account for deferred compensation because it forms part of the total consideration paid to a shareholder who leaves the practice.

Cash basis accounting book value. This formula also deducts liabilities from assets, but accounts receivable and payable, as well as other accrued assets and liabilities, are excluded.

Set price per share. The share price is set according to a measure such as the par value of the practice's common shares.



These formulas can result in inaccurate values for several reasons. The use of a depreciating basis for assets such as real estate can produce sums at odds with true market value. The cash basis formula doesn't tap lucrative accounts receivable and work-in-progress. The par value of common shares is typically low. And all of these formulas ignore valuable intangible assets such as goodwill.

Determining the real buy-in price

At first glance, it can appear that a professional joining a practice pays a simple flat fee. In reality, it's more complicated because the professional often forfeits significantly more than the mere share price.

Suppose a physician spends three years working as an employee before paying in \$5,000 to become a shareholder. During those three years, the physician earns less than the practice's full shareholders, so that reduced compensation represents an additional cost of his buy-in to the practice. An expert could argue that the actual buy-in equals \$5,000 plus the present value of the lost compensation.

Of course, if the physician is fresh out of medical school when he first joins the practice as an employee, he logically will earn less than doctors with more experience. Thus, the true buy-in value is likely more than \$5,000 but less than \$5,000 plus the present value of the pay differential. The difficulty in reaching an accurate amount may make it more useful to base the value on the *buy-out* price, even if the buy-sell agreement uses the same price for both buy-in and buy-out.

Determining the real buy-out price

Buy-sell agreements frequently provide for deferred compensation based on, for example, a professional's average compensation over the preceding three years. The deferred compensation is usually paid over a period of years, without interest, and far exceeds the share price.

Professional practices generally use deferred compensation for tax reasons. While a practice can deduct such compensation from its taxable income, thereby cutting the after-tax cost of a buyout, the practice's payment for the departing physician's share isn't deductible. Protracted deferred compensation also reduces the impact on a practice's cash flow.

Valuations of professional practice shares should account for deferred compensation because it forms part of the total consideration paid to a shareholder who leaves the practice. The professional may argue that it represents retirement

compensation, but that argument might prove shaky if the professional also receives pension or similar benefits.

Going on the offensive

Attorneys can wield both the buy-in range described above and a buy-out calculation comprising the share price and deferred compensation to dispute the reasonableness of an opposing expert's overstated valuation. If a share in the practice is really worth, say, \$1 million, why would existing shareholders accept a buy-in amount far below that figure? Similarly, why would a departing professional be willing to sell back shares for less than \$1 million?



Remember, however, that different states lend varying amounts of weight to buy-sell agreements in valuation situations, so consider the relevant case law. ■

Goodwill in a professional practice

One of the trickier issues associated with valuing a professional practice is how to characterize the practice's goodwill. The key question: Is it practice or professional goodwill? The answer can dramatically affect a practice's value, particularly in a divorce context.

Practice goodwill relates to the practice's ability to generate revenue even without the involvement of a specific partner. It includes the practice's name, reputation, location, technology and recurring client base, along with the quality of its staff, services and procedures. Professional goodwill is based on an individual's reputation, education, experience, skills and successes.

Factors considered might include:

- The uniqueness of the service the professional provides, and his or her degree of specialization,
- The professional's source of clients,
- The degree to which the practice's partners share clients, and
- The professional's billing rates and the number of billable hours.

In many states, professional goodwill isn't considered a marital asset, but practice goodwill is. So, in those states, the nonprofessional spouse prefers that the practice be found to have more *practice* goodwill, while the professional spouse hopes for more *professional* goodwill.

Court excludes husband's pension payments from taxable wages

Last year, the U.S. Tax Court ruled in *Dunkin v. Commissioner* that payments made under a divorce decree dividing community property — representing the wife's share of her spouse's as-yet untapped pension — were excludible from his wages. The court's reasoning could also apply in community property states other than California.

The marriage ends, but the pension continues

The Dunkins divorced on Aug. 19, 1997. The husband worked for the city of Los Angeles and had become eligible to receive his pension on May 19, 1989. He did not, however, retire at that time.



Under California community property law, each spouse takes a one-half ownership interest in the community estate, including income and deferred compensation such as pensions earned by both spouses during the marriage. A former spouse is entitled to payments based on the amount of pension benefits the employee-spouse would receive if he or she retired as soon as eligible.

The court observed that the rationale is to prevent the employee-spouse from depriving the other spouse of his or her interest in retirement benefits by “transmuting community property into separate property.” The divorce decree declared that the wife was entitled to half of the husband's pension earned during the marriage, or \$2,072 per month, and ordered the husband to pay her that amount until he retired. In accordance with the decree, he paid his former wife about \$26,000 in 2000; he deducted a similar amount from his federal tax return as alimony. The IRS argued the payments were taxable to the husband.

Court rebuffs the IRS

The IRS made three arguments to support its position — all of which the court rejected. It first argued that, because the

husband wasn't yet receiving pension benefits, payments to his wife were taxable “on account of her community property rights in his pension.” The court found that this argument overlooks the fact that California community property rights don't depend on the form of the payments received by the employee-spouse or the source of the payments to the former spouse. Likewise, the court held that federal taxation shouldn't depend on the form — current wages or retirement benefits — of payments to the former spouse.

The IRS also posited that the payments were an assignment of income and thus taxable to the husband. But the court cited a 1930 U.S. Supreme Court case where, under the community property law in Washington state, each spouse was taxed on one-half of his or her income and one-half of the other spouse's income. The Supreme Court noted that the earnings of a taxpayer in a community property state belong to the community, not the taxpayer earning them. The Tax Court ruled that Dunkin's payments here also derived from community property, rather than from his taxable property.

Finally the IRS contended that, because the payments weren't distributed directly from the pension plan, they were tax free to the wife under Section 402 of the Internal Revenue Code — which addresses the taxation of distributions made from a qualified trust under a qualified pension plan. And if they weren't taxable to the wife, they must be taxable to the husband. The court dismissed this argument, as well, pointing out that Section 402 did not apply because the distributions weren't made from a qualified trust.

The IRS asserted that, if the parties had used a qualified domestic relations order (QDRO), the payments would have been taxable to the wife. But the court found that, even if the husband could have obtained a QDRO providing an early retirement benefit to the wife, federal law didn't prohibit the actual arrangement the former spouses made.

Avoiding taxation trap

Taxation issues that arise from payments related to divorce are complicated, especially because courts don't consider the labels applied in divorce agreements determinative. Tread carefully to avoid shackling your clients with unnecessary taxes. ■

Is depreciation in a business interruption claim a saved expense?

Insurers and claimants face off

Insurance companies and claimants continue to debate the appropriate treatment of depreciation in business interruption claims. Insurers argue that depreciation should be treated as a saved expense deducted from the loss amount because depreciation terminates with the destruction of an asset. Claimants maintain the reduced depreciation should be expensed during the interruption and that depreciation is a noncash item irrelevant to the amount of the loss.

Point and counterpoint

The disagreement between insurers and claimants centers on several issues:

Roles of indemnity. Business interruption insurance is intended to place an insured in the same financial position it would be but for the insured incident. Claimants contend that depreciation has no impact on a company's financial position; it is solely an accounting charge and doesn't represent cash inflows or outflows.

Insurers deny that their position undermines the principle of indemnity. If an insured receives reimbursement for both the depreciated asset itself and depreciation, it receives compensation for more than its actual loss, satisfying indemnification.

Claimants contend that depreciation has no impact on a company's financial position; it is solely an accounting charge and doesn't represent cash inflows or outflows.

Useful service life. Depreciation is based on an asset's estimated useful service life, and claimants argue that the estimate may differ significantly from the actual service life. If the actual life is longer, the insurer's deduction of depreciation from the loss amount will be overstated.

Insurers concede the possibility of variances between estimated and actual service lives, and claim that in such situations



adjusters may change the depreciation method used to reduce the amount of the depreciation deduction. But depreciation, they insist, is nonetheless a discontinued expense.

Accounting gains vs. depreciation. After insurance proceeds are received, claimants typically record an accounting gain on the disposal of the asset if the proceeds exceed the asset's remaining net book value at the time of loss. Claimants assert that the gain is a noncash item, and, under the insurer's reasoning for deducting depreciation, the claim amount should also be reduced for the gain. Such a calculation would obviously be improper, and so, too, is the insurer's calculation of the claim amount less depreciation.

Insurers respond that the gain is so recorded because the proceeds generally provide sufficient funds to replace the lost asset. The claimant thereby recovers the asset's initial costs, eliminating the need for additional recovery in the form of continued depreciation.

Reduced maintenance expenses. Claimants propose that, if the claim amount is indeed to be reduced, it should be cut by any saved repair and maintenance expenses. Such expenses would offset depreciation.

Insurers counter that generally accepted accounting principles require the capitalization of expenses that extend an asset's life — rather than allowing them to be recorded as an expense. Repair and maintenance expenditures would rightly appear as additions to capital assets. As such, maintenance expenses should also discontinue when an asset is destroyed.

Future increased depreciation. Claimants note that future depreciation costs will grow because of the higher costs of a replacement asset. To reimburse the insured for this increase, they suggest the insurer should reimburse them for the depreciation between the loss and replacement.

Insurers believe the insured is “trading up” a depreciated asset for a new asset with a full lifespan and new product improvements, while recording the proceeds as though the asset were sold to the insurer. The gain recorded on the books should account for the increased depreciation resulting from the insurer paying a higher amount than the undepreciated cost on the insured's books.

An ongoing debate

Bear in mind the myriad arguments available when dealing with business interruption claims involving depreciated assets. Different state courts accept different logic, so it pays to prepare for whatever tack your opponent might take, while building your own arguments. ■

How experts value loss of enjoyment damages

Loss of enjoyment of life damages, or hedonic damages, have been around since the early 20th century but have gained more widespread acceptance only recently. Many states began allowing hedonic damages in the 1990s, and such damages continue to generate case law today — especially in cases involving little or no lost income.

Establishing a value

Financial experts apply several methods to calculate hedonic damages. Frequently, they base them on the amount people are willing to pay to reduce the risk of death. To do this, the cost of a safety device, such as an airbag, is multiplied by the number of devices needed to actually save a life.

Government safety studies often are incorporated in the calculation. For example, if a study indicates that airbags would save one life if purchased by 5,000 people, and an airbag costs \$500, the value of a life is set at $5,000 \times \$500$, or \$2.5 million. A similar approach takes a consumer perspective, relying on the amount surveyed consumers report they would pay for a safety device, rather than its actual market cost.

Another method bases hedonic damages on wages paid for dangerous jobs. The increased amount of compensation required to induce someone to perform such a job is multiplied by the increased risk of death, providing a basis for the damages.

Tailoring value to the individual

Once the value of life is determined, an expert multiplies that figure by the victim's percentage impairment. If a



plaintiff can function at only 75% of his or her preinjury function, the expert multiplies the 25% impairment by the life value, making adjustments for the plaintiff's life expectancy and any pre-existing disabilities.

Alternatively, an expert deducts the lifetime earnings for the average person from the life value. That figure is considered the value of the average person's ability to enjoy life. It assumes that annual value of life is reduced to the present value of the loss according to the plaintiff's life expectancy.

Not just for plaintiffs

The advantages of hedonic damages calculations for plaintiffs are obvious, but they also can benefit defendants. Defense attorneys may use such calculations in cases where a jury might be swayed by emotions and to a large verdict primarily out of sympathy. Arguments for hedonic damages can help contain runaway jury verdicts by assigning actual value to the loss of enjoyment of life.

Data mining digs up the dirt on fraud

Often, companies that suspect employees of fraudulent behavior don't realize they're sitting on mountains of electronic data that could serve as a rich source of evidence. With data mining, companies can use their own data on financial transactions, customers, vendors and employees to detect fraud.

Data mining extracts information from volumes of data and uses it to uncover hidden patterns, trends or inconsistencies that can help narrow the focus of an investigation. When investigating fraud, data mining experts usually look for data that differ from that expected for nonfraudulent transactions. With the company's help, an expert can establish rules to identify "normal" behavior so that abnormal, possibly fraudulent, behavior stands out.

Drilling the data

One common application of data mining is to match employee addresses against vendor addresses. Investigators might find that vendor checks are going to employees, which usually violates company policies against employees acting as



vendors or may indicate fraudulent misappropriation. Sorting vendor lists by address also can reveal that purportedly different vendors are using the same address, perhaps to evade a company limitation on the amount of business that can be conducted with a single vendor or other rules.

Missing deductions or exemptions in payroll records could correspond to ghost employees.

Another data mining approach is to sort vendor lists by payment size. Businesses might be surprised to learn which vendors rank at the top of the list and may not even recognize them. In some cases, a highly paid vendor turns out to be a shell company set up by an employee. An expert may also sort vendor payments over time, looking for dramatic jumps and instances where increased payments don't correspond with increased goods or services received.

Payroll and expense reports provide a wealth of information, too. Missing deductions or exemptions in payroll records could correspond to ghost employees. Mining expense reports can identify an unusual number of expenses in even amounts (\$11.00 vs. \$10.54), expenses that come in just under the amount that requires receipts for reimbursement or submissions of the same expense twice — often using both the actual transaction receipt and the credit card receipt.

Finally, data mining can spot suspicious gaps in sequences, pointing to missing checks. The sequencing of invoice numbers also merits attention; if a vendor's bills lack gaps in the invoice numbers — meaning the company is the vendor's only customer — fraud is possible.

Sifting gold from the glitter

It's important to realize that data mining doesn't necessarily provide cold, hard proof of fraud. Data mining merely raises red flags that call for additional investigation. False positives that aren't thoroughly investigated before action is taken can prove costly, so retain a fraud examiner to determine whether fraud is actually occurring. ■