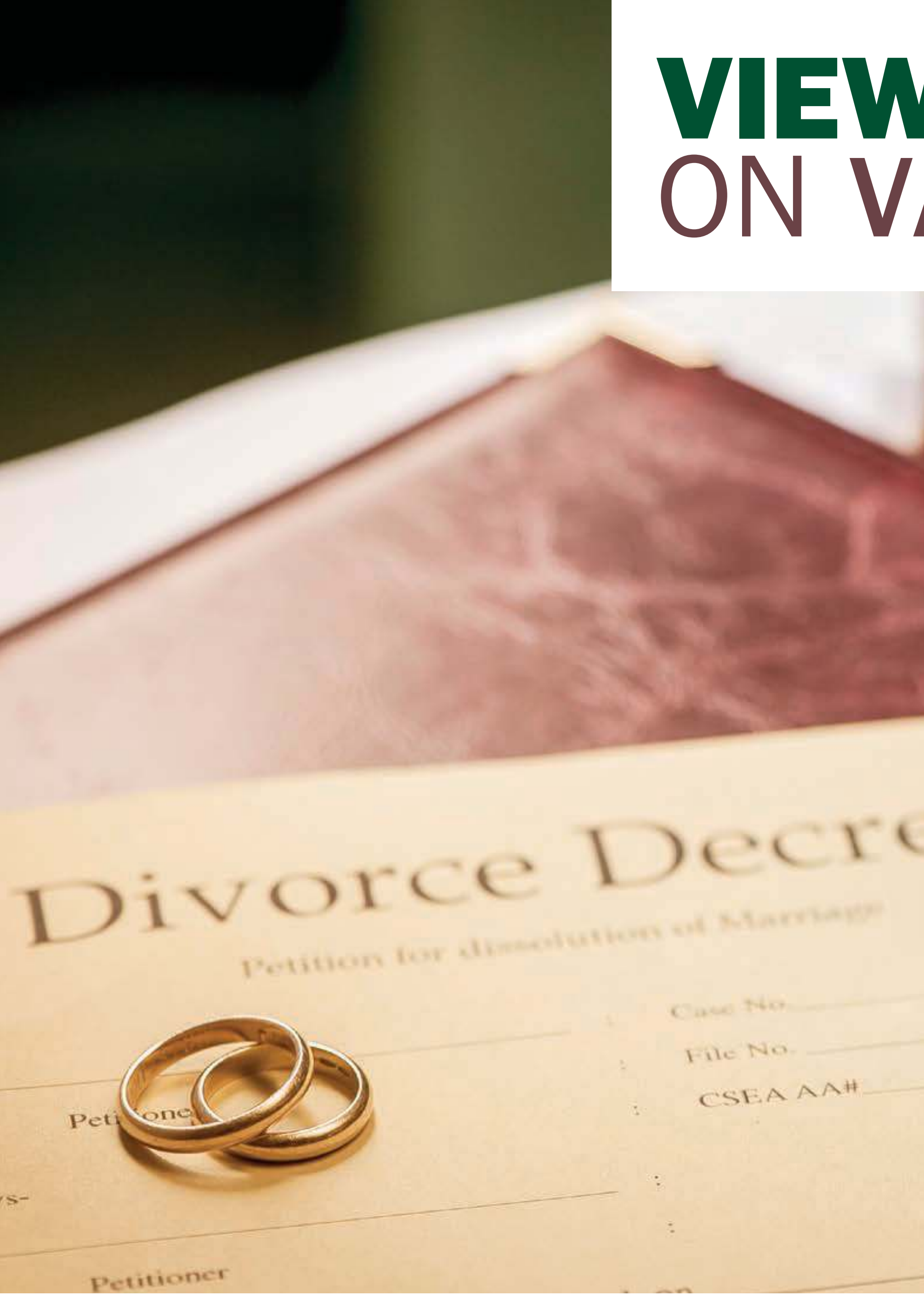
VIEWPOINT ON VALUE



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Tax issues play a central role in divorce settlements

Divorcing spouses often hire financial experts to help brainstorm settlement options, particularly when the marital estate includes a private business interest. In addition to valuing business interests that are owned by the couple, business valuation experts understand the critical federal tax issues that come into play when determining support payments and divvying up assets.

Support payments

When the spouses' abilities to earn income differ significantly or one spouse has primary custody of minor children, the divorce settlement will likely include alimony (maintenance) and child support payments. These payments are subject to different tax treatments, however.

Alimony is taxable to the recipient and deductible for adjusted gross income for the payer, as long as the payments meet the tax code. However, child support is never taxable (or deductible to the payer).

Depending on the spouses' tax brackets, maintenance payments and tax breaks may become valuable bargaining tools in settlement talks. Some items (such as child credits and deductions for dependents) may be phased out for higher income individuals. Others (like mortgage interest) may not have value to a taxpayer who doesn't itemize deductions on his or her tax return.

Property settlements

When divorcing spouses exchange assets, it doesn't usually trigger federal income tax or gift tax consequences. Tax-free treatment for property transfers between spouses applies before the divorce, at the time the divorce becomes final and after the divorce provided the transfers are done per the terms of a

Can a divorcee qualify for "innocent spouse" relief?

Married taxpayers who file a joint federal income tax return generally are jointly and severally liable for the tax reported (or reportable) on the tax return. If the IRS uncovers tax deficiencies on a joint tax return, the government can pursue both spouses jointly or either spouse individually to collect the entire liability.

Joint liability often seems unfair, especially in the aftermath of a difficult divorce. In many instances, the IRS issues a deficiency notice long after the divorce has been finalized.

Divorced taxpayers may be able to use the "innocent spouse" rules to relieve themselves of a tax obligation if they're unaware of their former spouses' tax avoidance schemes, receive no benefit from the hidden income and lack the financial wherewithal to pay the entire liability.

Divorced taxpayers can also elect to separate tax deficiencies (but not tax underpayments) based on the portion for which they're directly responsible. To be eligible for this form of relief, the electing spouse must not have actual knowledge of the understatement.

If all else fails, divorcees can request "equitable relief." Here, the taxpayer throws himself or herself on the mercy of the IRS. The U.S. Tax Court has no jurisdiction over equitable relief claims, however.

divorce property settlement. The exception to this general rule is transfers of retirement accounts. To split up retirement accounts without unfavorable tax consequences, the transfer must always be made pursuant to a qualified divorce or separation agreement.

Following a tax-free transfer of a business ownership interest, the buyer-spouse generally takes over the seller-spouse's tax basis and holding period for the stock purchased. So, the buyer-spouse doesn't receive a stepped-up basis when the transfer occurs, and he or she will incur taxes on any gain when it's eventually sold. Receiving a business interest with significant built-in gains isn't the same as receiving a lump sum of cash. Thus, an adjustment may be needed to arrive at an equitable distribution of the marital estate.

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Likewise, real estate and other investments may create taxable gains when they're sold. Some couples opt to sell these assets before the divorce is final to eliminate any uncertainty about future tax obligations and to take advantage of the higher home-sale gain exclusion on the principal residence, which is $250,000 for a single taxpayer and $500,000 for a married couple (if they meet certain use and ownership tests).

Corporate redemptions

If the couple owns a business interest and they agree that the corporation should buy out a spouse's business interest, the transaction usually triggers a gain or loss upfront — and, therefore, results in a stepped-up basis for the buyer-spouse. Who bears the tax burden in corporate redemptions?

If the corporation redeems the shares to fulfill a spouse's obligation to buy those shares under the couple's divorce agreement, the deal is treated as if the buyer-spouse received a redemption payment and then exchanged it for the shares. Under this scenario, the seller-spouse has no tax consequences; instead, the buyer-spouse bears the tax burden.

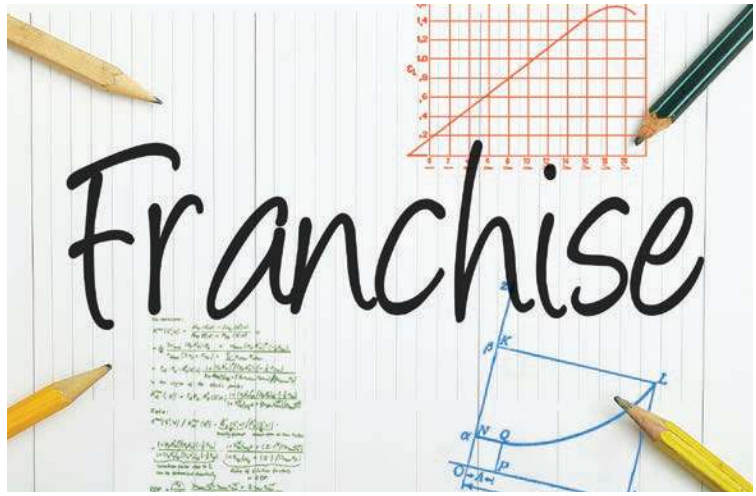
However, if the transaction is structured as a sale strictly between the seller-spouse and the corporation, the seller-spouse can generally treat the redemption as a sale of stock back to the corporation or as a corporate dividend. This deal structure is often preferred, because the seller-spouse can offset the stock redemption payment with his or her basis in the redeemed shares. In this situation, the seller-spouse bears all the tax consequences — and the other buyer-spouse bears none.

Put an expert on your team

When crafting a divorce settlement, it's essential to consider tax issues and address them in the divorce decree. Contact a business valuation professional to help find the optimal settlement option. ■

Valuing franchises

There's more to franchising than fast food restaurants and auto dealerships. Today, franchising opportunities exist in many different industry segments, including retail, health care, professional services, real estate, education and child care, fitness, and hospitality. With so many franchising options, one thing is clear: Not all franchises are created equal. Here's a look at the special considerations that factor into a franchise business valuation.



Weigh the pros and cons

The nature of franchising may lead you to believe that a franchise is significantly more valuable than an otherwise identical standalone business. But that's not always the case for a variety of reasons.

As with any business, the value of a franchise is a function of risk and return. A franchised business may seem to carry little risk because its brand is established and the franchisor provides administrative support, including marketing programs, accounting systems, operating manuals and training. The franchisor also may pass along volume purchasing discounts from suppliers to its franchisees.

Evaluate the return

The franchisor's support comes at a substantial cost, however, which can vary substantially depending on the franchise you're investing in. Those costs typically include:

Franchise fee. This upfront charge generally ranges from about $50,000 to $200,000, though some franchise fees may be higher or lower depending on the brand and geographic market. Additionally, the franchisee must pay professional fees and build-out costs to get started.

Royalties. Once open, the franchisee must pay ongoing royalties to the franchisor that typically range from 4% to 8% of gross revenues and include an ongoing assessment for a joint marketing and advertising fund. The franchisee also may be required to purchase uniforms, inventory and other supplies from the franchisor, as well as update the facilities to comply with the franchisor's appearance standards.

As a result of these costs, most franchisees don't report positive operating cash flow until they've been in business for several years. To help forecast revenue and costs, a business valuation expert will ask for a copy of the franchise disclosure document. Required by the Federal Trade Commission, this document provides insight into start-up costs and fees, average monthly sales, and projected revenue growth.

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Beware of restrictions

A franchised business may look even less attractive to investors if the franchisor restricts the owner's actions. Examples include covenants that restrict independent marketing efforts, relocation and ownership transfers.

Business valuation professionals review the franchise agreement to get a handle on these restrictions. A discount may be warranted if the agreement limits the franchisee's rights to expand, sell to a third party, or respond to changing trends and market demographics.

Consider market trends

When valuing a franchise, experts typically evaluate how the brand and the industry measure up to others. Franchisees are most satisfied when franchisors continually reinvent their brands and offerings, invest in training programs, support customer retention efforts and grant flexibility to respond to changing market conditions. Strong franchisors also adapt to regulatory changes, such as emerging tax laws, health care reporting requirements, and minimum wage and overtime rules.

Each year, the *Franchise Business Review* surveys franchisee satisfaction for hundreds of brands. Valuation experts may be able to download a free satisfaction "snapshot" from this source when considering how a particular brand ranks among its comparables.

Need help?

When valuing a franchise, it's important to understand the relationship between the franchisee and its franchisor. Risk and control are considerations when valuing any business. On the one hand, franchisors may lower risk by providing support and brand recognition. On the other, franchisors may exercise control over a franchisee, detracting from the value of a franchise. A business valuation expert can help you evaluate the upsides and downsides of investing in a franchise. ■

Bombardier Rec. Prods. v. Arctic Cat Inc.

Are draft reports discoverable?

Draft reports generally aren't discoverable in federal courts under Federal Rule of Civil Procedure (FRCP) 26. This rule was modified starting in 2010 to specifically exclude from discovery draft reports, expert notes and other expert-attorney communications. The reasons for these exclusions were twofold: to reduce the cost of discovery and to facilitate freer exchange of information between attorneys and expert witnesses.

Some expert communications aren't covered by the new-and-improved FRCP 26, however. Here's a pretrial ruling in a recent patent infringement case that illustrates an important exception.

Drafts with editorial comments

During discovery, the defendant in a recent patent infringement case (*Bombardier Rec. Prods. v. Arctic Cat Inc.*) filed a motion to obtain copies of draft expert reports from the plaintiff. The plaintiff had hired various financial experts to evaluate alleged infringement of patents involving snowmobile frame construction and seat positioning. Before finalizing their reports, the experts shared their drafts and subsequently returned the drafts with editorial comments. They exchanged reports as a "quality assurance measure."

The court's ruling honed in on critical exceptions to the FRCP evidence admissibility provisions: Communications still open to discovery include written documents about expert witness compensation, as well as any facts, data or assumptions the attorney supplied that provided the basis for the expert's opinion.

"At issue here is not an unadulterated expert report draft copy. At issue here are three expert report drafts with editorial comments prepared by a different expert, which each issuing expert reviewed and considered before finalizing their respective expert report." As a result, the district court concluded that the editorial comments, along with the corresponding draft reports, had to be produced.

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Lessons learned

Though it's not clear what the editorial comments specifically said in *Bombardier*, the defendant was probably looking for weaknesses in an expert's report and discrepancies between the experts' assumptions and analyses. What's more, the ruling also included the production of the draft reports, which normally would have been excluded from discovery if they hadn't been adulterated. The court decided that drafts were needed to help understand the experts' editorial comments.

The takeaway from this case is: If you want to limit the risk that an expert's draft reports and other communications (such as editorial comments, notes and emails) will be subject to discovery, try to communicate *verbally* whenever

possible to avoid leaving a paper trail that may be discoverable. This lesson applies to redlining of an expert's draft report by other experts, as well as by clients and attorneys.

It's also important to understand the reasons FRCP 26 was updated. Any expert-attorney communications that provide facts, data or assumptions to support the expert's opinion still may be fair game. That's because they help the parties understand the expert's methodology and conclusions. Unadulterated draft reports aren't discoverable under FRCP 26, because they're considered a work-in-process rather than a final work product.

Moreover, the exemption of draft reports applies only in federal courts. Some state and district courts haven't modified their rules to match FRCP 26. And the rule applies to discovery, not to admissibility during trial.

Bottom line

Bombardier is one of many cases that demonstrate the limits of the new-and-improved FRCP 26. Sharing draft reports and other documents isn't taboo, but it's critical, whenever possible, to share editorial comments in a format that can't be handed over to the opposing side during discovery. ■

Public vs. private companies: Understand the key differences

Public company data often is used to value private businesses. But there are important differences between how public and private entities operate — and your business valuation expert may need to adjust his or her methodology to account for these differences.

How public and private companies differ

Public companies are generally considered less risky than private companies. Why? Public companies tend to be large, have professional management teams and offer diversified products and services. Many operate globally. They issue audited financial statements on a quarterly basis and must report major equity transactions to the Securities and Exchange Commission (SEC).

By contrast, private companies can be large or small, but most have less than $10 million in annual revenue. They're often run by families or a small group of managers who "wear multiple hats." As a result, private companies tend to have fewer internal controls to prevent fraud and cyberattacks than public ones.

The smallest private companies might not even follow U.S. Generally Accepted Accounting Principles (GAAP) when preparing their financial statements, opting instead to use cash-basis or tax-basis reporting methods. A top priority when private companies prepare financial statements is to *minimize* taxable income — a sharp contrast to public companies that generally try to *maximize* earnings per share to satisfy investors.

Why use public market data

Given the significant differences between public and private companies, why do experts use public company data to value private businesses? Between SEC filings, press releases and news stories, there's a lot of reliable information on public companies to collect and analyze.

Business valuation experts use this information to draw conclusions about 1) market returns on equity and 2) relationships between market value (such as stock price or transaction price) and financial metrics (such as EPS, operating cash flow or pretax income).

How to account for these differences

Before applying public company returns or pricing multiples to the subject company, an expert asks this critical question: "What adjustments are needed to make the comparison between the *public* market data and this particular *private* company more relevant?"

Adjustments are especially important when applying public stock data that's reported on a minority, marketable basis to a controlling interest in a private company. Adjustments for differences in the level of control and marketability are critical. After all, minority investors in a public company typically have no control over day-to-day operations, but they can sell their stock with relative ease.

Get it right

When adjusting public company data, there's a risk of doubling up on adjustments. So, it's important to use an experienced business valuation expert who's aware of the differences and knows how to account for them. ■

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Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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