Advocate's EDGE

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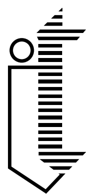
March/April 2011



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1225 Franklin Avenue • Garden City, NY 11530 • (516) 240-3300
350 Fifth Avenue • New York, NY 10118 • (212) 239-3300
www.israeloff.com

Recent ruling provides an owner compensation primer

It's not unusual for the IRS to question the compensation that closely held companies pay their owners. If one of your clients has come under scrutiny, the recent Tax Court decision in *Multi-Pak Corp. v. Commissioner* provides a primer on the factors that often come into play in such cases.

WHO'S BEING UNREASONABLE?

After Multi-Pak's founder died in 1972, his son Randall Unthank became the company's CEO and sole shareholder. The C corporation's earnings at that time were down, and its management had considered filing for bankruptcy, but Unthank brought Multi-Pak back from the brink.

Beginning in 1972, Unthank performed all of the company's managerial duties and made all personnel decisions. He was in charge of Multi-Pak's price negotiations, product design, machine design and functionality, and administration. The company has generally been profitable and it hasn't used debt.

In 2002 and 2003, Unthank's compensation was approximately $2 million annually. The IRS, however, determined that his reasonable compensation would have been only $655,000 and $660,000, respectively. Multi-Pak appealed the IRS's assessment.

THE TAX COURT COMETH

The Tax Court considered whether Multi-Pak's deductions for Unthank's compensation were reasonable under Internal Revenue Code Section 162. Sec. 162 allows companies to deduct ordinary and normal business expenses, including a "reasonable allowance for salaries or other compensation for personal services actually rendered."

To evaluate the reasonableness of Unthank's compensation, the court applied five factors articulated in the Ninth Circuit's 1983 decision *Elliotts, Inc. v. Commissioner*:

1. Employee's role. This focuses on the employee's importance to the success of the business, including his or her position, hours worked and duties performed. The court found that, during 2002 and 2003, Unthank "made every important decision" for Multi-Pak's operations, and that his efforts "directly contributed" to its financial conditions. The factor therefore weighed in Multi-Pak's favor.

2. Comparison with other companies. How does compensation compare with that paid by similar companies for similar services? This factor frequently calls for expert testimony, but the court found neither party's expert convincing because their comparables were too dissimilar to Multi-Pak. The court deemed the factor neutral.

3. Company's character and condition. The third factor considers the company's size as measured by its sales, net income or capital value; the complexities of the business; and general economic conditions. The court found that Multi-Pak was prominent in its industry. And even when its revenue declined from 2002 to 2003, the company's equity, revenue and gross profits were its highest ever in 2002 and 2003. The factor favored Multi-Pak.

4. Potential conflicts of interest. When an employee controls a company, his or her relationship with it is closely scrutinized. For example, does the relationship allow the company to disguise nondeductible corporate distributions as compensation? This problem is less common in subchapter S corporations, however, where owner-operators may do the opposite — attempt to disguise owner compensation as distributions. When compensation is understated to avoid payroll taxes, the IRS may still challenge the amount.

> *Sec. 162 allows companies to deduct ordinary and normal business expenses, including a "reasonable allowance for salaries or other compensation for personal services actually rendered."*

In *Multi-Pak*, the Tax Court applied the "independent investor test." According to the test, if the company's earnings on equity after payment of the owner's compensation would satisfy a hypothetical independent investor, the compensation would probably be reasonable. The court concluded that the test favored Multi-Pak in 2002, but not in 2003.

5. Internal consistency. An internal inconsistency in the company's compensation policies may indicate that the payments are unreasonable compensation. The court, however, found that Multi-Pak's incentive-based compensation policy was consistent.

Based largely on this independent investor test, the Tax Court concluded that Unthank's 2002 compensation (which would provide a 2.9% return on equity) was reasonable, if not very conservative, but his 2003 compensation (-15.8% return) should be reduced.

APPLYING ANALYSIS

The fact pattern in *Multi-Pak* is a common one, so the court's analysis provides a valuable roadmap for withstanding IRS challenges. Qualified experts can apply this analysis and others to enable you to prevail in court or even preempt litigation altogether.

Maximizing recovery from a fidelity insurance policy

An Association of Certified Fraud Examiners (ACFE) study estimates that the average organization loses 5% of its annual revenue to employee fraud, with a median loss of $160,000 among the reported cases. Some of your clients may have fidelity insurance to protect themselves from such dramatic losses. Unfortunately, this type of policy is no guarantee: Claimants must follow strict procedures, and claims often are contested. But a qualified fraud expert can help you and your clients build a stronger claim.

PROBLEMS AND SOLUTIONS

ACFE research has found that organizations pursue civil actions against occupational fraud perpetrators in less than 25% of cases — generally the most costly schemes of more than $1 million. Although victimized organizations settle or receive favorable verdicts in nearly 98% of those cases, they rarely recover the full amounts of their losses. Fidelity insurance is designed to help bridge the gap.

PROVING LOSS IS HARDER THAN YOU THINK

Fidelity insurance claimants that fail to follow proof-of-loss documentation rules to the letter could delay or even preclude recovery. A company's policy will detail the specific data it must provide. But proof of loss typically requires, at a minimum, detailed accounts that include:

- The names of the alleged perpetrators, their positions in the company, their dates of employment and whether they've been terminated,
- Any known fraudulent or dishonest acts previously committed by the perpetrators,
- Events surrounding the loss, including transactions, amounts, dates, names, addresses and phone numbers,
- Discovery of the loss, including dates and people involved,
- Methods used to conduct the investigation, and
- How the loss was calculated.

In addition, claimants should include copies of all documents used in the investigation, any statements taken, police reports, and other policies or bonds that might apply to the loss.

Fidelity policies typically impose strict deadlines, particularly when it comes to providing notice to the insurer and submitting claims. If these rules aren't met, a claimant could forfeit its coverage. Because few organizations employ people with the necessary experience to properly investigate occupational fraud incidents and provide insurers with the right information on time, they should hire a fraud expert.

Enlisting the help of an expert can increase the odds of satisfying insurer deadlines and maximizing recovery under a policy. Fidelity coverage usually includes reimbursement of investigation and claim preparation costs — which practically makes the decision to hire an expert a no-brainer.

THE CLAIMS PROCESS

Fraud experts closely review a company's fidelity insurance policy before launching an investigation. Familiarity with a policy's requirements enables them to align an investigation and resulting documentation with an insurer's requirements. Once those parameters are established, a fraud expert works with the claimant's own investigation team to collect and analyze data as well as conduct interviews with anyone who might have relevant information or insights.

After concluding an investigation, the expert quantifies the company's loss and prepares documentation to submit to the insurance company. Such documentation must describe the allegations, investigation and findings, and can take the form of a formal report, spreadsheets, timelines or flowcharts. The insurer will use this information to evaluate the company's claim, and the documents may also be used in subsequent legal proceedings — whether they involve the insurer or the perpetrator.

While preparing documentation, a fraud expert also can identify any potential weak points in a claim and explain to the insurer why the weaknesses aren't as significant as they might seem. Finally, the expert might review reports from the insurer's experts and draft responses, if appropriate.

MOVING ON

Maximizing recovery from a fidelity insurance policy shouldn't be your client's only concern. Defrauded companies also need to consider instituting appropriate measures to prevent fraud schemes in the future.

Fidelity policies typically impose strict deadlines, particularly when it comes to providing notice to the insurer and submitting claims.

Occupational fraud often occurs in organizations that have failed to make and formalize internal controls or that have become lax in enforcing them, as in the case of management overrides. A fraud expert can evaluate your client's existing policies and procedures and suggest improvements to minimize the likelihood that employees will find new fraud opportunities.

DON'T CUT CORNERS

Constructing and submitting a claim under a fidelity insurance policy is a complicated process that calls for the input of a fraud expert experienced in working with insurance companies. Don't let your clients cut corners: It could reduce the amount of their recovery.

Let a rebuttal expert break your valuation deadlock

A dermatologist going through a divorce hired a valuator to appraise his medical practice. The expert estimated a value of $800,000. His wife's valuator, however, estimated the practice to be worth $3 million. Which appraiser is wrong?

Possibly neither one of them is. Valuators use a variety of methods and inputs when appraising a business, making it easy for two experts working in good faith to reach different conclusions. In such situations, litigating parties must find a way to break the deadlock. A rebuttal report can help them do that — as well as reduce overall valuation costs.

HOW DO THEY WORK?

Rebuttal reports generally are prepared by a third valuation expert jointly hired by both parties. However, they also can be prepared by one or both of the original valuators.

Rebuttal reports are designed to facilitate settlement by pinpointing differences between divergent valuation reports and putting technical appraisal issues in more user-friendly language. The rebuttal expert sorts through the minutiae of the two conflicting appraisals and identifies specific sticking points. To help the parties make an informed decision, the expert also offers citations and reference materials.

FROM AMBIGUOUS TO SPECIFIC

Rebuttal reports are useful not only in matrimonial cases, but in many types of litigation. Take a fictional auto-parts manufacturer. One of its two partners would like to dissolve her interest in the business, so she hires an appraiser who values it at $6 million. Her partner's expert, however, estimates that the business is worth $4.5 million. Neither side will split the $1.5 million difference.

They jointly hire a rebuttal expert who reviews both reports and concludes that the appraisals are remarkably similar, except for two key differences:

1. An adjustment for excess partners' compensation, and

2. An addback for excess working capital.

As a result, the dispute evolves from a complex question about the value of the business to a list of more manageable issues. For example, how much are the partners' day-to-day contributions worth? Compared with its competitors, does the shop have excess cash on hand and, if so, how much?

ELEMENT OF SURPRISE

Rebuttal reports come in all shapes and sizes. The appropriate length and format depend on the time and resources available, as well as whether the parties are using a neutral third expert or the original valuators.

Some experts and attorneys prefer oral rebuttals, arguing that less formal discussions generate no tangible report for the opposition to review before court. Accordingly, oral reports help preserve the element of surprise and minimize client costs.

The primary downside is that oral rebuttals require attorneys to understand technical appraisal issues well enough to design salient deposition and trial questions. Incomplete testimony often misses key points and frustrates everyone involved. Oral rebuttals also provide judges and jurors with nothing to review during deliberations.

QUANTIFYING ERRORS

Court procedural rules and professional appraisal standards provide little guidance for written rebuttal reports. Their length and detail, therefore, are dictated by the needs of the attorney and requirements of the jurisdiction. Federal courts, for example, have stricter standards than most state courts.

Content generally includes a description of the appraiser's review procedures and a list of errors and omissions (or "findings and conclusions"). To demonstrate objectivity, rebuttal experts disclose all errors and omissions, not just those that support a client's financial interests. Many experts also attempt to quantify how errors — individually and collectively — might affect their opinion.

The rebuttal expert sorts through the minutiae of the two conflicting appraisals and identifies specific sticking points.

COMMON GROUND

As attorneys know, vague disagreements can easily become protracted battles. Rebuttal experts make valuation disputes more explicit and easier to understand. This can help the parties find common ground, even when in the case of divorce almost every issue seems to be a contentious one.

Attorney-client privilege

Are e-mails on company computers protected?

These days, employers regularly provide employees with electronic communication equipment such as laptops and mobile phones. Not surprisingly, questions often arise about employees' expectations of privacy. In one 2010 employment discrimination case, *Stengart v. Loving Care Agency*, the New Jersey Supreme Court considered whether e-mails that the employee had sent her attorney using an employer-owned laptop were protected by attorney-client privilege.

WAS PRIVILEGE WAIVED?

Marina Stengart used her company-issued laptop to exchange e-mails with her attorney through her password-protected Yahoo!® Mail account. After Stengart filed an employment discrimination lawsuit, her employer hired a computer forensic expert to recover files stored on the laptop.

The expert uncovered the e-mails, which had been automatically saved on the computer's hard drive. Stengart's attorney asserted that the e-mails were privileged communications and sought relief in court. The trial court held that, in light of the company's electronic communication policy, Stengart had waived privilege by sending the e-mails on a company computer. The court of appeals reversed, and the case moved to the state supreme court.

REASONABLE PRIVACY EXPECTATIONS

The court found that e-mail exchanges clearly are covered by attorney-client privilege. It went on to consider whether Stengart had a reasonable expectation of privacy in the e-mails.

The court noted that other courts have ruled that employees have a lesser expectation of privacy when they communicate with an attorney using a company e-mail system — as opposed to a personal account. Courts have also indicated that the existence of an explicit company policy banning personal e-mails can diminish the reasonableness of employees' claims to privacy in e-mail with their attorneys.

Here, the employer's electronic communication policy didn't address personal e-mail accounts, meaning employees didn't have specific notice that messages sent or received on such accounts were subject to monitoring. The policy also didn't warn employees that their e-mails could be forensically retrieved.

Moreover, the e-mails at issue weren't illegal or inappropriate material that could harm the employer in some way. Under the circumstances, Stengart could reasonably expect that the e-mails would remain private, and, as stated by the court, "it follows that the attorney-client privilege protects those e-mails."

RETRIEVABLE VS. DISCOVERABLE

It's worth noting that the court also found that the employer's attorneys had violated the rules of professional conduct by reviewing and using Stengart's e-mails. You and your clients can avoid this kind of trouble by remembering that a *retrievable* communication isn't necessarily *discoverable*.

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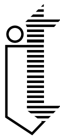

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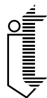

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212.239.3300

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