The Witness Chair

Leading-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

WINTER 2005 ISSUE 40

Separate Is Not Equal: Taxes and Domestic Partners: Part One

by Roberta Bennett, Esq.

Effective Jan. 1, 2005, California registered domestic partners (CRDP) under AB 205 (codified in Family Code Sec. 297.5 and 299) gained almost all of the state-based rights and responsibilities of a married couple. Through clean-up legislation in AB 2580, the Domestic Partnership Act (the Act) is retroactive to the date the couple registered their domestic partnership with the state.

However, the Act does not give CRDPs any of the tax benefits given to spouses by the federal government, such as joint filing, the unlimited marital deduction for estate tax, and other tax exemption benefits. The clash between state community property laws and federal tax laws produces more questions than answers at this point.

The best advice for CRDPs is to take consistent positions on their respective tax returns. Clients should be advised, in writing, of the many uncertainties of the federal tax treatment of CRDPs. Be sure to add a Circular 230 (Rev. 6-2005) disclaimer to any written advice to CRDPs.

We do know that the filing status of a CRDP is either single or, if there is a qualified dependent, head-of-household. The Act provides that CRDPs must use their federal filing status, which, under the federal Defense of Marriage Act (DOMA) prohibits joint filing status for unmarried individuals. The other CRDP cannot be a qualified dependent for head-of-household status because of the absence of a familial relationship. However, there is the possibility of an exemption if one partner qualifies as a dependent under IRC Sec. 152.

Less clear is the concept of community income for tax purposes. The presumption in family law that any property acquired and debts incurred during the marriage are community, now will be applied to CRDPs. Further, this will be applied retroactively to the date they registered with the state.

Community assets are normally created with the spouses' earnings. This earned income is reportable one-half by each spouse on his or her tax return regardless of who actually earned it [*Poe v. Seaborn* (1930) 282US 101, 111; Treas. Reg. Sec. 1.66-1(a)]. As most married couples file jointly, the income splitting generally is irrelevant.

However, for CRDPs, the Act provides that "earned income may not be treated as community property for state income tax purposes" [Family Code Sec. 295.5(g)]. Does this mean that for federal tax purposes, earned income is split, but not on state returns? Or does this mean that earned income is not split on either the federal or state tax return and is reportable only by the earning CRDP?

The confusion arises because federal tax law follows state property law for determining the character of income. This indicates that the earned income of CRDPs should be split on federal returns under *Poe v. Seaborn*. Note that the provision "for state income tax purposes" is state tax law, not state property law.

On the other hand, the IRS could take the position that the legislative intent of the provision "earned income may not be treated as community property for state income tax purposes" is that it also applies for federal tax purposes, especially in light of the federal DOMA. This would indicate that the income is the earning CRDP's separate property income for tax purposes. So for tax purposes when and how would this income transform into community property?

If earned income is "separate" for tax purposes, but "community" for state property law purposes, an absurd result could be that every paycheck creates a taxable gift to the non-earning CRDP for one-half. While IRC Sec. 2523 will exclude

Continued on Page 6

In this Issue

Section ACTION

Business Valuation

by Ted D. Israel, CPA

The AICPA's National Accreditation Commission's recent ABV resolution is designed to "embrace the most qualified CPAs who are providing valuation services." Through July 31, 2006, a CPA who is an AICPA member in good standing and holding another valuation credential earned via a proctored exam is eligible for the ABV credential. Such candidate also will have to attest to a minimum of 500 hours of valuation experience and be sponsored by a single ABV in an employer or supervisor role, or two ABVs not connected to the candidate's employment, but sufficiently familiar with the CPA's work.

The valuation credentials considered eligible and their accrediting organization include American Society of Appraisers (AM), Institute of Business Appraisers (CBA), CFA Institute (CFA), and National Association of Certified Valuation Analysts (CVA). A proctored exam is one given under supervision as opposed to a take-home exam.

One reason for this outreach is numbers. In October 2003, the AICPA set the goal of credentialing 2,700 ABVs by 2008, the estimated minimum number needed to keep the program economically viable. As of July 31, there were 1,749 ABVs. The interest is there, but many CPAs already were credentialed by organizations established before the ABV program. So, why not invite them to become ABVs?

All the organizations involved took a good look at the body of knowledge and examinations required to obtain the other credentials and determined them to be roughly equivalent to those of the ABV. The admission of additional qualified valuation professionals will strengthen the ABV brand and should advance the evolution of consistent standards and practices.

Ted D. Israel, CPA, ABV, CVA is the Business Valuation Section chair and a partner at Eckhoff Accountancy Corporation in San Rafael.

Economic Damages

by Lynn Carl Jones, CPA

The measurement of business interruption losses often is based on the past performance of the impacted business and, when available, the post-impact performance of the business. Intervening factors are considered and quantified as appropriate. In the case of business destruction, either a measure of expected future profits or business value immediately prior to destruction might be used.

This analysis breaks down when a business is interrupted for an indefinite period. Indefinite interruptions occurred after Sept. 11, 2001, and follow natural disasters such as earthquakes, floods, tsunamis, or hurricanes. Indefinite period interruption is a perennial issue to California practitioners.

Actions by the New York courts since 2001 provide some guidance for such interruption when the claim is against an insurer. In *Duane Reade, Inc. v. St. Paul Fire & Marine Insurance Co.* [No. 03-9064, 2005 U.S. App. LEXIS 11965 (2nd Cir. June 22, 2005)], the court ruled that the operative interruption period was the theoretical time required to rebuild the building that housed the business—not any longer actual time because it would be inappropriate to penalize the insurer for a process over which it has no control, *i.e.*, the actual rebuilding of a site.

In *Paradies Shops v. Hartford Fire Insurance Company* [No. 1:03-CV-3154 (N.D. Ga. Dec. 15, 2004)], the court ruled that a period of interruption caused by civil authorities restricting access to the business is included in the business interruption period when access restrictions resulted from the destruction of real property.

In *Streamline Capital LLC v. Hartford Fire Insurance Company* [No. 02-CIV-8123, 2004 WL 22004888 (S.D.N.Y. Aug. 25, 2003)], the court held that the interruption period was only the time required to restore business operations at another location.

Practitioners may consider this reasoning on the measure of "indefinite", while also considering if the time to regain market share may be shortchanged by using a theoretical interruption period. The cases cited all dealt with insurance—disputes between non-insurance parties are another matter. Both are appropriate for expert analysis and opinion.

Lynn Carl Jones, CPA, CFE is the Economic Damages Section chair and managing principal of Jones & Co.

Family Law

by Leslie O. Dawson, CPA

Rather than provide separate spousal and child support payments, marital settlement agreements often combine the two into one payment. Generally, the goal is to qualify the entire payment as alimony under IRC Sec. 71 and shift the tax burden of the entire amount to the spouse in the lower tax bracket.

To qualify under IRC Sec. 71, payments must terminate upon the death of the payee and there must be no liability to make any substitute payments thereafter. This requirement can pose a problem if it is deemed that the payor's liability for child support will survive the death of the payee. *Lovejoy v. Commissioner* (293 F.3d 1208-2002), *Gonzales v. Commissioner* (TC Memo 1999-332), and *Hawley v. Commissioner* (93 AFTR 2d 2004-1821) all disqualified the family support payments based on the continued obligation of the payor for the child support after the payee's death.

However, *Kean v. Commissioner* (Nos. 04-2931 & 04-3018 – 3d Cir. 2005) and *Berry v. Commissioner* (TC Memo 2005-91) suggest that when the parties share joint legal and physical custody, custody of the children would revert to the payor upon the death of the payee. Thus, the obligation for child support under the marital settlement agreement would not survive the death of the payee. In other words, there would be no continued obligation for a payment to another party. The payor automatically would obtain custody of the children and support them directly. *Kean* pertained to a temporary support order, while *Berry* involved a permanent support order.

Given the mandatory child support guidelines and the differences in the above rulings, the taxability of family support is still murky. However, it appears that stating in the marital settlement agreement that the payments are intended to qualify under IRC Sec. 71, will terminate upon the death of the payee, and that custody will automatically revert to the payor may help secure qualification as deductible support.

Leslie O. Dawson, CPA is Family Law Section chair and a partner in Glenn & Dawson LLP in Walnut Creek.

Fraud

by Peter A. Salomon, CPA

Online investment fraud is becoming an increasing prevalent way for criminals to target consumers. The SEC is attempting to crack down on online investment fraud. An example is the market manipulation case against Systems of Excellence (SOE), SOE's chairman and CEO Charles Huttoe, and 12 other defendants.

SOE's ticker symbol was SEXI. The defendants secretly distributed more than 40 million unregistered, but purportedly, free-trading shares of SOE stock to family members and friends, drove up the stock price with false press releases disclosing an acquisition and multimillion-dollar sales deals, and made unsupported revenue projections showing significant growth. Huttoe also bribed, with unregistered securities, the owner of an online newsletter that promoted largely unknown penny stocks and small capitalization companies to tout the value of SOE shares. The online newsletter owner violated federal securities laws by failing to disclose he had received compensation from SOE to tout its stock.

Six individuals were convicted of felony charges. Huttoe and the owner of the online newsletter were sentenced to federal prison for 46 months and 12 months, respectively. The SEC froze the assets of Huttoe and other defendants and has recovered approximately $15 million in illegal profits, which it plans to distribute to investors.

Before an investment is purchased online, due diligence in determining if the investment has been registered with the SEC or with a state agency, or is subject to a registration exemption should be done. If an investment has not been registered with the SEC or a Form D has not been filed with the SEC, check with the North American Securities Administrators Association, *www.nasaa.org*, to find securities regulators for every state. You can check for complaints related to potential investments. Also, beware of investment opportunities in countries other than the United States and offshore investments.

Peter A. Salomon, CPA is Fraud Section chair and a director in Navigant Consulting's Litigation and Investigations practice in Los Angeles.

Message from the Chair

by Andy Mintzer, CPA

The AICPA is at the forefront of a couple of proposals affecting litigation service practitioners and their clients. The *Proposed Statement on Standards for Valuation Services* stirred up so much controversy that the AICPA extended the comment deadline three months. The Litigation Sections Steering Committee sent an addendum comment letter. At press time, the AICPA had not announced how—if at all—the proposed standards will be modified, and whether or not they will be issued.

The AICPA also has issued an exposure draft on proposed ethics rulings that among other things, defines when an auditor is or is not considered independent.

Key to the proposal affecting litigation services is the principle that independence would be impaired when an expectation of confidentiality of information between the practitioner and the client/client attorney exists, and the communication of any information uncovered by the practitioner during the course of the forensic engagement is restricted by the attorney-client privilege or attorney-work product doctrine, and, therefore, cannot be shared with the attest engagement team.

Simply put, CPAs who perform attest functions likely will be unable to remain independent if they perform litigation services. This prohibition, largely in effect for auditors of public companies, is extended by this proposal to auditors of all companies. I recommend all practitioners involved with litigation services review this proposal as it defines "forensic accounting services," "litigation services," and "investigative services." You can read the proposed ethics interpretations at *www.aicpa.org*. The steering committee has sent a comment letter to the AICPA. Comment letters are posted on our website.

Finally, many people have asked me how they can become involved on the steering committee or as an officer in the individual sections. Now is your chance. Application information can be found on Page 5.

Andy Mintzer, CPA, CFE is a sole practitioner based in Santa Monica.

Keepin' It Legal

Experts and Attorneys: Joint and Several Defendants?

by Randall J. Dean, Esq.
and Karen D. Morse, Esq.

You have just been retained as an accounting expert in a lawsuit involving various breaches of fiduciary duties. However, your assignment is limited to assessing some documents and perhaps providing a declaration to some moving papers.

Unease begins to settle in when you realize that you will not be advising the client or the court directly and you will have to trust the attorney(s) to communicate your assessments accurately to protect you from potential liability.

What if your assessments are communicated negligently? What if the documents you were given were insufficient to ascertain an informed opinion? Are you now liable to the client on whose behalf you were retained?

The answer is yes, but the retaining attorney also may be liable to you.

Previously, an expert could be held 100 percent liable to a client, despite the existence of the retaining attorney's concurrent negligence. However, developing case law compares litigation support professionals with concurrent counsel, and as such, allows for indemnification where appropriate.

Equitable Indemnity and the Attorney Exception

The issue of attorneys bringing cross-claims for indemnity against successor attorneys has been addressed extensively in California courts, most recently in *Forensis Group v. Frantz, Townsend & Foldenauer*, [(2005) 130 Cal.App.4th 14, 29].

Until recently, most courts barred such claims due to public policy concerns, as in *Major Clients Agency v. Diemer* [(1998) 67 Cal.App.4th 1116, 1129]. Some of these concerns include preventing conflicts of interest between attorneys and clients and protecting the confidentiality of attorney-client communications, as in *Musser v. Provencher* [(2002) 28 Cal.4th 274].

The holdings that barred such claims due to public policy are known as the "'attorney exception' to the general rule allowing indemnity to be sought among joint tortfeasors," as stated in *Forensis*, citing *American Motorcycle Assn v. Superior Court* [(1978) 20 Cal.3d 578, 598-607].

The Progressive Erosion of the Attorney Exception

Notwithstanding the importance of public policy, the California Supreme Court held in *Musser* that it did not require the "adoption of a blanket rule barring concurrent counsel or co-counsel from suing one another for indemnification ..."

In *Musser*, a bankruptcy attorney retained by a client gave co-counsel inaccurate legal advice, which resulted in co-counsel's malpractice liability. Consequently, co-counsel sought indemnity from the bankruptcy attorney.

Despite the important public policy concerns raised in objection, the Court did not preclude indemnification since there was no evidence that the attorney's self-interest in defending an indemnification claim would interfere with the continuing fiduciary duty of loyalty owed to his client. As such, a court's decision to allow indemnification between attorneys should be determined on a case-by-case basis.

Experts and Attorneys as Concurrent Tortfeasors

What about experts seeking indemnity from retaining attorneys? In *Forensis*, the court was faced with this issue: whether the expert and retaining attorney may be considered concurrent tortfeasors for purposes of indemnification. The court held in the affirmative, applying the same logic set forth in the concurrent representation case of *Musser*.

In *Forensis*, a client sued an expert for professional negligence, alleging that the expert's lack of expertise caused him to lose the underlying action. When the expert sought indemnification from the retaining attorney, the attorney argued that public policy barred the action because it 1) created a conflict of interest with his former client; and 2) threatened the protection of attorney-client communications.

However, the court agreed with the expert's contention that negligent lawyers should not be shielded from liability, quoting the *California Expert Witness Guide*, Cont.Ed.Bar 2d ed. 2005, Sec. 8.28, p. 290: "Regardless of the expert's skill, it is the lawyer's responsibility to make sure that his/her expertise is presented to the trier of fact in an admissible and persuasive way." As litigation support professionals, the expert and referral firm were "similar in function to concurrent counsel."

Since the indemnity action focused on "legal strategy and litigation decisions," neither the client nor attorney-client communications were involved. Therefore, there was no conflict of interest.

Moreover, the interdependent nature of the attorney/expert relationship was influential. In *Forensis*, the expert necessarily relied on the attorney to present the law and his expert opinion in a professionally competent manner. This reliance was proper since the expert himself could not communicate with the court.

Continued on Page 5

AICPA Alert

by Jeffrey H. Kinrich, CPA

The status of the AICPA's *Proposed Statement on Standards for Valuation Services* has been a recurring theme of these updates over the past few years. More often than not, the standards have been moving forward, but at a slower pace than expected. This theme continues.

The proposed valuation standards were released for public comment earlier this year. At the time, the comment period was expected to end in June. Due to loud objections by portions of the tax community, led by several members in California, the comment period was extended to Sept. 30.

Certain tax practitioners object to the establishment of standards for valuations used in tax returns. The BV community generally has responded that there is no reason for such an exclusion, and that since a large portion of valuations are tax-related, such an exclusion would gut the standards.

The AICPA is expected to make a final decision in the next few months.

The AICPA Professional Ethics Executive Committee released an exposure draft (ED) Sept. 15 titled *Proposed Interpretation 101-16, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, under Rule 101, Independence;* and *Proposed Interpretation 101-17, Performance of Client Advocacy Services, Fact Witness Testimony, and Forensic Accounting Services, under Rule 101, Independence*. The proposed new interpretation, 101-17, will be in addition to existing interpretations 102-6 and 101-3. The ED prescribes how services rendered by forensic accountants impact independence with attest clients.

The ED is available at *www.aicpa.org/members/div/ethics/2005_0915_omnibus_ED.htm*.

The AICPA sponsors several valuable conferences each year, including the Fraud and Litigation Conference, held in September, and the Business Valuation Conference, held in November. Attendees receive high-quality CPE and the opportunity to mingle with peers from across the country. The AICPA Conference Planning Committee will form soon for next year. If you are interested in serving on one of the planning committees, let me know.

After two years of work by many dedicated volunteers, the Forensic and Litigation Services Committee has approved the publication of a practice aid on intellectual property damages. Look for its release in late January or February. The committee's next practice aid will be on lost profits. If you are interested in working on the document, let me know.

We recently celebrated the one-year anniversary of the BV/FLS member section and the BV/FLS website, *http://bvfls.aicpa.org/*. If you have not visited the website recently, I encourage you to do so. It is frequently updated and contains valuable information. We are always seeking content for the website. If you have any articles or materials you would like to have published on the website, I can be reached at *jkinrich@analysisgroup.com*.

Jeffrey H. Kinrich, CPA, ABV is a managing principal of Analysis Group in Los Angeles.

Experts and Attorneys

Continued from Page 4

So, when your expert services are next requested, try to convey the importance of a complete evaluation before reaching your conclusion. However, should the attorney communicate your conclusion negligently, rest assured that the law provides you with recourse.

Randall Dean, Esq. is a partner with Chapman, Glucksman & Dean specializing in accountants' malpractice. Karen D. Morse, Esq. is an associate with the firm.

Litigation Sections Leadership Application

The Litigation Sections is beginning its nominations and selection process for the steering committee and individual sections officers. "The goal is to involve more members in leadership opportunities and development, and to continually enhance the diverse composition of the leadership team," says Litigation Sections Nominations Committee Chair Don Gursey.

For 2006-08 there are three member at large positions open on the steering committee and each individual section is seeking nominees for officer positions. All Litigation Sections CPA members are eligible to apply and self-nominations are strongly encouraged. Each position has a two-year term.

What does leadership offer? It is an opportunity to contribute to the development of the litigation, valuation, damages, forensic, and family law practice areas; to work on discussion papers and standards review; assist in the development of classes and conferences with the Education Foundation; plan individual section meetings; and much more. The steering committee meets four times a year and each section meets three to four times a year.

Enclosed is the Leadership Application. The form is also available online at *www.calcpa.org/LIT*. Selected applicants for the open positions will be announced in Spring 2006.

For more information, contact Bobbie Nochenson, (818) 546-3502; Maria N. Nazario, (818) 546-3506; or Don Gursey, (310) 552-0960.

Application deadline is Friday, Jan. 16.

HAPPENINGS

Litigation Sections Meetings

Business Valuation	Thursday, Jan. 26, LAX Thursday, May 11, OAK Thursday, July 27, LAX Thursday, Sept. 28, OAK
Economic Damages	Wednesday, Feb. 22, LAX Thursday, May 4, LAX
Family Law	Friday, Jan. 27, LAX Friday, May 12, OAK Friday, July 28, LAX Friday, Sept. 29, OAK
Fraud	Tuesday, Feb. 21, LAX May 2006, TBA

Each section will send individual meeting notices.
Download a copy at *www.calcpa.org/LIT*
or contact Bobbie Nochenson at (818) 546-3502

Education Foundation Course Offerings—(800) 877-5897 or www.educationfoundation.org

Internal Control and Fraud Prevention and Detection	Jan. 17, San Fernando Valley Jan. 19, OAK
Searching for Fraud: Assessing Risk and Addressing Red Flags	Jan. 20, SFO Feb. 3, San Diego
Finding and Evaluating Frauds: A Case Study Approach	Jan. 24, San Jose
Stopping Fraud in Your Business	Jan. 25, SF Feb. 10, San Fernando Valley
Fraud: The New Audit Paradigm	Jan. 26, Marin/Sonoma County
Fraud: Exposures and Solutions in the Non-Audit Environment	Jan. 27, Marin/Sonoma County
Tracing and Business Valuation	Feb. 6, Marin/Sonoma County

Domestic Partners

Continued from Page 1

gifts between spouses from gift tax, no such exclusion exists for CRDPs. To complicate this scenario further, is the non-earning CRDP's half interest only as to the net earnings after taxes or to the pre-tax earnings?

Another big issue is determining which CRDP deducts what community debts and expenses. For instance, who receives the deduction for state income taxes on the federal return? The tax is paid by the earning CRDP and, arguably, not a community liability because the earnings are not community for state tax purposes. However, if the earnings belong to the community, has each domestic partner paid half of a separate liability of the other partner?

These are just a few of the questions facing tax preparers and family law practitioners this year.

Part two of this article regarding what happens during the "divorce" will appear in the Spring 2006 issue.

Circular 230 Note: Tax advice, if any, contained in this article was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any tax-related matter addressed herein.

This article is for informational purposes only and does not constitute legal advice or a legal opinion on any specific facts or circumstances. The contents are intended as general information only.

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We welcome your letters, articles, comments and suggestions, which may be sent to the editors at *bleeck@pacbell.net*.

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