

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

8300 BOONE BLVD
SUITE 250
TYSONS CORNER
VIENNA, VIRGINIA
22182
(703)288-2900

DECEMBER 2009 - JANUARY 2010

LITIGATION COURT REJECTS EXPERT WITNESS'S LEGAL AND CONCLUSORY OPINIONS

Rule 702 of the Federal Rules of Evidence specifically allows expert witness opinion testimony when it will assist the trier of fact to understand the evidence, but only if "(1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case." A recent ruling barring proffered expert testimony in a discrimination lawsuit in the U.S. District Court for the District of Columbia demonstrates that the Court takes its role as *gatekeeper* seriously and will not allow a litigant to bolster his or her case with trumped up lay opinion testimony masquerading as *expert* testimony.

In the case *Sykes v. Napolitano*, D.D.C. No. C.A. 0-42 (June 25, 2009), a Secret Service Officer's complaint developed from his undesired transfer from a billet as Special Agent in Charge of the protective detail for Lady Byrd Johnson in Texas to Assistant Special Agent in Charge of a training facility in Maryland. Although the transfer did not reflect a reduction in rank or pay, Plaintiff alleged it was a *de*

continued on page 3

IN THIS ISSUE

LITIGATION: Court Rejects Expert Witness's Legal and Conclusory Opinion	1
TAX: Reasonable Compensation—Part 1	1
TAX: 2010 Estate Tax—A Brave New World.....	2
INSURANCE: Bad Faith Claims—Tort or Contract?	3
STAFF NOTES	4

TAX REASONABLE COMPENSATION – PART I

Section 162 of the Internal Revenue Code allows a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. When the taxpayer is a closely-held C corporation and the salary in question is that of an employee who is also a major shareholder, it might be in the shareholder's interest to maximize salary payments since salaries are deductible but dividends are not. Typically, in setting the salary level, the corporate officers would ask the company's accountant to calculate what salary level would minimize overall tax burden, that is, corporate income tax, personal income tax on salaries, personal income tax on dividends and payroll taxes for Social Security and Medicare.

After the corporation makes its determination based on tax factors, however, the Internal Revenue Service (IRS) might challenge the salary set as being too high and really a disguised dividend. (In the context of S corporations, the Service might challenge a salary as being too low. We will come back to this issue in Part III). Over the years the courts have considered a number of factors to determine whether compensation is or is not reasonable. Court decisions depend on the facts of each case, and no one factor is decisive. Below we list and briefly discuss the principal factors considered by courts over the years:

Salary History. The salary history of a particular individual is important. When salary changes dramatically from year to year, the Service will want to know what triggered the change. If salary increases by almost the exact amount profits have increased, this might indicate a disguised dividend.

Dividend History. For the same reason the dividend history of the corporation is important. Small dividends or no dividends might mean disguised dividends paid in the form of salary. Also decreasing dividends with a corresponding increase in salary might be suspect. A year-end bonus, when profits of the corporation can be accurately predicted, might be a disguised dividend.

Board Resolutions. Salaries should be determined formally by the board of directors. If corporate formalities are not followed in closely-held corporations, salaries set might be subject to attack.

Arm's Length Transactions. Salaries should be negotiated. If true negotiation is difficult in the context of a closely-held corporation, salaries should be set so the resulting salary would be the one obtaining after negotiation. For example a highly qualified individual would normally command a higher salary than a less qualified one. Salaries should be proportional to the results obtained by an employee, and reasonably objective criteria should be used to measure results. The IRS would look at the relative pay of different individuals to see if the differences are merited or artificial. Pay practices in the industry are also relevant.

Other Factors. The courts have also looked at the job description of employees, the complexity of the business, salaries as a percent of sales and of net income before tax, and whether the economy is booming or in recession.

Independent Investor Test. Because there has been so much litigation on this issue and, in the opinion of many, so little light shed by the courts, a newer test has been developed. What salary would be set by an independent investor who is interested above all else in maximizing his or her return from investment in the corporation? Under this view, a salary would be

continued on page 2

TAX
2010 ESTATE TAX--A
BRAVE NEW WORLD

If you expect to leave a sizeable estate to your heirs, January 1, 2010, may have been a once in a lifetime opportunity to pass away, from an estate tax perspective. However, it is a little premature to feel disappointed if you missed that date. If nothing else, Estate & Gift taxation is a moving target. A little background, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") provides for a scheduled phase-out of the estate tax, effectively raising the exemption amount from \$1,000,000 in 2000 to *unlimited* in 2010. For reference purposes, the exemption amount was \$3,500,000 in 2009 (\$7,000,000 for married couples with proper estate planning), meaning that a decedent could leave \$3,500,000 to his heirs tax-free in 2009, provided he did not previously make any gifts exceeding the annual exclusion amount during his lifetime. As of January 1, 2010, by the blackletter law of the IRS Code, an individual passing away in 2010, can leave an unlimited amount to his heirs free of federal estate taxation. Note that the federal gift tax remains in effect during 2010, but at a lower 35% rate, and there continues to be a \$1,000,000 lifetime gift tax exemption and an annual gift tax exclusion of \$13,000 per donee. EGTRRA sunsets in 2011, the estate tax exemption amount reverts to \$1,000,000 and the tax rate thereafter reverts to 55%.

So how did we get to this point? The EGTRRA was never meant as a permanent solution; as drafted its provisions allow for a one-year repeal of estate taxation in 2010 and then reinstatement to a much lower exemption amount in 2011. Since passage of EGTRRA, nearly all estate planning professionals expected the legislature to agree on a compromise resolution prior to 2010. The consensus expectation was a continuation of 2009's \$3,500,000 exemption amount, with future inflation adjustments. Prior to the New Year, the U.S. House of Representatives was able to pass a bill that would have extended the federal estate tax at the \$3,500,000 exemption amount; however, the Senate, presumably tied up in the Health Care Reform debate, was not able to address the issue, leaving the 2010 repeal of the federal estate in effect to the great surprise of the estate planning com-

munity. Nevertheless, Congress is likely to pass a reinstatement of the estate taxes in some form this year, to apply retroactively to January 1, 2010. In such a situation, it is a near certainty that some individual, or the personal representatives of such individual, who passed away between January 1, 2010, and whenever Congress passes a new estate tax bill, will challenge its constitutionality on *ex post facto* grounds. This will surely be an interesting issue for constitutional law scholars to debate as and when such a challenge is heard.

As mentioned above, estate tax is a moving target, and we can only be certain concerning the application of current law. So, under current law (the 2010 repeal of the estate tax), what are the tax ramifications of passing away in 2010? Yes, you can pass an unlimited amount of your assets to your heirs free of estate tax; but, the largest negative impact will be borne by your heirs on the tax treatment of inherited assets. Prior to 2010, the cost basis for assets held by a decedent would "step-up" to the fair market value of the asset on the decedent's date of death, eliminating a capital gains tax on any pre-death appreciation. For example, prior to 2010, when you inherited your parents' house, your basis in the house is the fair market value of the house at the time of their death – therefore, when you sold the house shortly thereafter you did not create any capital gains because your basis in the house was equal to the sales price. With repeal of the estate tax in 2010, the "step-up" in basis at death for inherited assets is replaced with a modified "carryover basis" system. Under the carryover basis system, assets generally will receive a basis equal to the basis of the decedent. The ramification of this is that when you inherit your parents' house, your basis is the same as their basis – likely creating capital gains on sale if the property has appreciated since purchase¹. This new carryover basis regime will, however, permit a decedent's representatives to allocate up to \$1,300,000 of increased basis to the decedent's assets in general, and an additional \$3,000,000 for assets passing to a surviving spouse. For those long advocating repeal of the "death" tax, an understanding of the implications of doing away with "step-up" basis may temper such enthusiasm. The vast majority of individuals pass away with less than \$3,500,000 in assets (\$7,000,000

for married couples), avoiding estate taxation (as of 2009) and their heirs avoiding income taxes for capital gains associated with the inherited assets via the "step-up" in basis – resulting in no tax liability whatsoever for the decedent and his heirs.

No matter what does or does not happen with estate taxes in 2010 and beyond, estate plans prepared in the last several years have anticipated such uncertainties and have been designed with maximum flexibility to accommodate such changing circumstances. However, re-evaluation of your estate planning needs, or the initial preparation of an estate plan, is always recommended, especially so given the current uncertainty in both the law, and in financial markets and asset values.

JUSTIN BANFORD

¹Not considering any capital gains exclusions applicable to the sale of primary residences.

TAX - PART 1

Continued from page 1
 reasonable if a hypothetical owner of the corporation would set such a salary. The hypothetical owner would presumably be willing to pay a very high salary to a CEO who can produce very high profits which would in turn result in very high dividends to the owner. The hypothetical owner could see a return on his investment of, say, 25% per year and pay accordingly.

If the CEO were to reach that fairly respectable return figure the CEO would receive a respectable salary. If the return were less than 25% then the CEO's pay would be penalized. Alternatively, the CEO could receive a low base salary, the rest of his pay being dependent on how close the return came to 25%. While this test can be manipulated by the owner-managers of a closely-held corporation, it has the advantage of quantification and objectivity which are sometimes lacking when utilizing the other factors.

In Part II of this article we will discuss a recent case which operationalizes the tests described in this part.

NÉSTOR CRUZ

Trivia answer: Roy Morris is a twin. His brother, Rex, is a food services professional in Oklahoma. Seeing them together is just downright...spooky.

INSURANCE**BAD FAITH CLAIMS—TORT OR CONTRACT?**

Implicit in the relationship between insurance companies and their customers is a duty to act fairly and in good faith. This duty includes, among other things, properly responding to claims, investigating damage and paying reasonable settlements when warranted. In the event an insurer fails to pay a claim or otherwise fails to perform its duties, an insured may sue his insurance company. The question arises as to whether the lawsuit is based in contract or tort. The tort-contract distinction is important as only tort claims provide for mental anguish and punitive damages, when applicable, thus allowing an insured to potentially recover an amount much greater than the value of his policy. Certainly, the insured may bring a breach of contract claim and be compensated for any actual damages. But, contract law may not compensate for behavior by the insurance company that was reckless or in bad faith. Accordingly, many states recognize a tort of *bad faith* by insurance companies. Bad faith implies or involves “actual or constructive fraud, or a design to mislead or deceive another, or a neglect or refusal to fulfill some duty or some contractual obligation, not prompted by an honest mistake as to one’s rights or duties, but by some interested or sinister motive. The term bad faith is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will.” *Black’s Law Dictionary, 5th ed.* Generally, the tort of bad faith in insurance transactions arises in two situations: (a) when the insured is seeking defense and indemnification from liability to a third party claim and (b) when the insured is seeking indemnification from the insurer for a loss.

A well-known example is the case of *Campbell v. State Farm* in which a jury in Utah in 2003 returned a verdict of \$145 million in punitive damages against State Farm. In that case the jury found that State Farm had acted unreasonably in refusing to settle the negligence and wrongful death lawsuits filed against Campbell, the insured,

by other motorists involved in accident for which Campbell was found to be 100% responsible. The Supreme Court of Utah held that State Farm subjected Campbell unnecessarily to the rigors of trial when Campbell faced a “near-certain probability of having a judgment entered against them in excess of policy limits.” There was additional evidence that State Farm had altered records to make Campbell look less culpable and had assured Campbell and his wife that their assets would be safe but, post-judgment, told them to put a “for-sale” sign in front of their home. The U.S. Supreme Court later held that the verdict was unreasonable and not in proportion to the wrong committed by State Farm and violated the due process clause of the Fourteenth Amendment. On remand the verdict against State Farm was reduced to roughly \$9 million.

Locally, however, Virginia, the District of Columbia and Maryland do not recognize a tort of bad faith by insurance companies in the handling of policy claims. For example, recently, in the case of *Choharis v. State Farm*, the D.C. Court of Appeals again reiterated its position that an insurance relationship is based on a contract between the insurance company and policy holder. In that case David Choharis, a DC homeowner and disgruntled State Farm customer, sued the insurance company for, among other things, bad faith in regards to State Farm’s handling of his claim of water damage to his home from a malfunctioning radiator. In April, 2001, Choharis’ home (including a basement rental apartment) sustained significant water damage due to a broken radiator. Hundreds of gallons of water flooded the home. Choharis was forced to move out and live in a hotel for over a year. During this time he had numerous disputes with State Farm including issues regarding their failure to provide temporary housing, properly investigate mold damage and compensate him for living expenses. The D.C. Court of Appeals explained that it is assumed that in every contractual relationship there is an implied obligation to act in good faith. Accordingly, if a policy holder has a dispute with its insurance agency he can sue based on breach of contract. All issues, including bad faith by the insurance company, can be addressed within this cause of action.

DANA THERIOT

LITIGATION

Continued from page 1

facto demotion and had been prompted by racial discrimination arising from improper handling of a sexual harassment claim by two subordinates in his former position. To support his claim Plaintiff proffered the opinion testimony of another former Secret Service agent. This *expert* had 26 years experience in the Secret Service plus additional government security experience. The witness was to testify on a broad range of matters, including the proper handling of the underlying harassment matter, the perceived “loss of status, earning potential, and upward mobility” occasioned by the transfer, the negative economic impact on Plaintiff caused by the transfer to the D.C. metropolitan area, and even the negative impact on post-retirement employment opportunities.

Ruling favorably on a defense motion to exclude the proffered expert testimony, Judge Rosemary M. Collyer unequivocally rejected Plaintiff’s argument that this was worthy expert opinion testimony. First, the Court readily dismissed the notion that the expert should be allowed to opine on the legal standard of a discrimination case. The expert would not be allowed to testify on the conclusion that the transfer at issue was an *adverse action*; that is a matter left to the judge and jury. Turning to testimony that Plaintiff’s professional reputation was damaged by the transfer, the proffered opinions were rejected for lack of foundation; the witness had no familiarity with Plaintiff’s reputation before or after the promotion. Opinions regarding economic injury were rejected because the expert knew nothing of the economic situation in Texas, that is, the testimony would be unsupported hearsay. The expert’s opinion of post-retirement impact reflected only the witness’s common sense analysis. Since the jury is entrusted to apply its own common sense, that opinion testimony was deemed unnecessary.

In essence the Court rejected Plaintiff’s expert because the witness’s opinions were proffered not to assist the jury but to supplant the jury.

LAWRENCE CARR

CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial litigation; Employment/Labor; Discrimination and Wage-Hour; Criminal; and Alternative Dispute Resolution.

The firm maintains its office in Tysons Corner, Virginia—the business hub of the metropolitan region. It has attorneys admitted to all of the local judicial jurisdictions.

STAFF NOTES

Margarita and Néstor Cruz spent Thanksgiving break in Germany. While in Munich they attended a performance of *Don Giovanni* at the Bavarian Court Opera.

* * *

Not-So-Easy Rider. Roy Morris and Tom Berger took advantage of Indian Summer for a Sunday motorcycle ride recently. Mechanical issues with Tom's BMW led to a warranty call in Harper's Ferry. Fulfilling a fundamental rule of the road, Roy generously gave Tom a ride home. *Is it just coincidence that motoring with Roy so often ends in needing a ride home?*

* * *

CMG trivia: Which CMG lawyer is a twin? Answer on p. 2.

* * *

Margarita and Néstor Cruz just celebrated their 40th wedding anniversary.

NEGLIGENCE

Continued from page 1

CARR, MORRIS & GRAEFF, P.C.
8300 BOONE BLVD, SUITE 250
VIENNA, VA 22182

PRSRT STD U.S. POSTAGE PAID Springfield, VA Permit No. 6082

RETURN SERVICE REQUESTED