

Kevane mailbag

March 26, 2015 – Issue 48


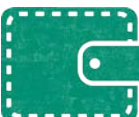



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Icon	Content
Audit 	On its February 18 meeting, the Financial Accounting Standards Board highlighted the fair value measurement disclosure framework. Read related information on page 2 .
Tax 	As fund raising events start to take place in preparation for election year in 2016, review the limits on political contributions in Puerto Rico. Read more on page 3 .
Advisory 	Learn how to discern lost profits from business valuation when measuring business damages. Access the article on page 4 .
Outsourcing 	Every year the Internal Revenue Service issues an update of publication 179-Puerto Rico Employer's Tax Guide- which should be used by employers whose principal business is located in Puerto Rico or who have employees that are subject to certain requirements. Read about this topic on page 7 .
General information 	<p>We have created a new section in our website www.kevane.com, under the Publications tab, in which we include a series of Tax Articles and links related to the proposed introduction of the valued added tax (VAT) and Tax Reform in Puerto Rico.</p> <p>These publications and its content do not constitute advice. Readers should not act solely on the basis of the material contained in these publications. They are intended for information purposes only and should not be regarded as specific advice. In addition, advice from proper consultant should be contained prior to taking action on any issue dealt with this update.</p>

Audit Alert: Fair value measurement disclosure framework

*The Financial Accounting Standards Board post highlights on its **February 18** Board meeting. The Board discussed how to promote more discretion in applying disclosure requirements about fair value measurements and tentatively decided that the disclosure sections of ASC Topics should:*

1) State that required disclosures must be provided only to the extent that they are material; 2) Omit language that would limit the use of discretion (for example, “An entity shall at a minimum provide...”); 3) Refer to ASC 235, *Notes to Financial Statements*, which the Board intends to modify to include the following additional guidance on applying materiality to note disclosures:

- Materiality would be applied to disclosures individually and in the aggregate; it is possible that only some or none of the disclosure requirements in the ASC Topic would be material.
- A disclosure would be material if it meets the U.S. Supreme Court’s description of “materiality.”
- The evaluation of materiality would be done on a quantitative and qualitative basis, including consideration of whether there is a substantial likelihood that the omitted disclosure could be reasonably viewed as having significantly altered the total mix of information made available.

- An omission would not be considered an accounting error if an entity omits the disclosure because it is deemed immaterial.

The Board tentatively decided that the guidance would not explicitly address the variations in the legal concept of materiality by jurisdiction. In addition, the Board tentatively decided that it would not distinguish between a minimum and expanded set of disclosures.

The Board also tentatively decided that the objective for the disclosures in ASC 820, *Fair Value Measurement*, would be “to provide users of financial statements with information useful” in assessing the different ways an entity arrives at its fair value measures, including judgments and assumptions that it makes; the effects of changes in fair value on the amounts reported in financial statements; the uncertainty in the fair value measurement of assets and liabilities and how fair value measurements change from period to period.

Source: Grant Thornton, *On The Horizon*, February 26, 2015

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Tax Alert: Political contributions limitations in Puerto Rico

Given that during 2015, fund raising events will start to take place in preparation for the election year in 2016, we review the current limitations on political contributions in Puerto Rico as stated by Act 222-2011, known as the Puerto Rico Political Campaign Financing Oversight Act, as amended.

The provisions of this Act state that no natural person may, directly or indirectly, make contributions in or outside of Puerto Rico to a political party, aspirant, candidate, campaign committee, authorized committee or political action committee in excess of the amounts established in 2 U.S.C. § 441a(a)(1)(A), as amended, or in any federal law that substitutes it. In general, the limits shall operate per calendar year.

The limits of the contributions for the 2016 General Election period shall be the following:

Individual Contributions made to:

- political party, aspirant, candidate, campaign committee, authorized committee or political action committee - \$2,600.00 each.
- independent Expenditures Committees or Segregated Funds Committee – No limit, unless the contribution is used by Independent Expenditures Committee or Segregated Funds Committee to make a donation to a political party, aspirant, candidate, campaign committee, authorized committee or political action committee, or agents or authorized representatives of any of the above, in which case the \$2,600.00 limit shall apply.
- contrary to the last election cycle, which carried a limitation of five (5) contributions per year, Act 222-2011, as amended, provides for unlimited contributions, without exceeding the \$2,600 per Political party, aspirant, candidate, campaign

committee, authorized committee or political action committee per natural year.

No juridical person may make contributions from its own funds in or outside of Puerto Rico to political parties, aspirants, candidates, campaign committees or to agents, representatives or committees authorized by any of the above mentioned, or to political action committees that make contributions or coordinate expenditures among themselves. However, a juridical person may establish, organize and administer a committee which shall be known as a segregated committee or fund that for purposes of contributions or expenditures shall be treated as a political action committee and which shall be registered at the Office of the Election Comptroller and shall comply with the provisions of Section 6.000.

Any donation in excess of two hundred (200) dollars will require contributor's identification, including name and last name, postal address, name of the person or entity to which the donation is being made, and identification number such as electoral number, Puerto Rico licence number, or any identification number issued by State or Federal Government that contains the person's legal name, birth date, gender, licence number or identification number, digital photo, residential address, signature, and physical security devices to prevent any type of manipulation, tampering, or duplication with fraudulent purposes.

Please contact our Tax Department should you require additional information regarding this or any other tax issue; we will be glad to assist you.



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Advisory Alert: Business damages measurement: Lost profits or business valuation?

Introduction

In business litigation matters, financial experts are often asked to provide an opinion on the quantification of economic damages suffered by an injured party. Business valuation and lost profits are two common damages estimation approaches used by financial experts. These two approaches share many similar economic and financial principles; however, some dissimilarity between these approaches can lead to very different outcomes. Therefore, consideration must be given as to which damages method is allowed and whether one method will make the injured party whole and the other not. Other questions arise: Can one apply both methods to the same damages calculation? Can lost profits exceed business value? Is one method more certain, or does it provide a better estimate, than the other? Do certain circumstances indicate that one method must be used?

Business valuation

Although each case is unique, there are circumstances in which the business valuation method almost always prevails over the lost profits method. Business valuation is applied almost exclusively in entire business destruction, shareholder oppression, dissenting shareholder, family law and tax court matters. In addition, permanent business value impairment (diminution in value) cases often rely on business valuation as an appropriate measure. These types of cases include M&A disputes, defamation, slander and intentional business destruction,

among other matters. A damages measurement in this type of case may be based on the difference between the value of the business in the but-for world and its actual value.

Lost profits

There are some cases, however, that apply lost profits rather than business valuation as the measure of damages, including breach of contract and intellectual property infringement. There are other circumstances in which it may be appropriate to apply either the lost profits method or the business valuation method. While the selection of a particular methodology is based on facts and circumstances, the lost profits method can be an appropriate measure of damages when the injury is for a specific period of time (and not into perpetuity as with a business valuation), or when the injury can be related to a separately identifiable cash flow.

Lost profits are commonly calculated based on the difference between the expected profits assuming the harmful event did not occur and the actual profits received (or if there will be future damages, what profits are estimated to be received).



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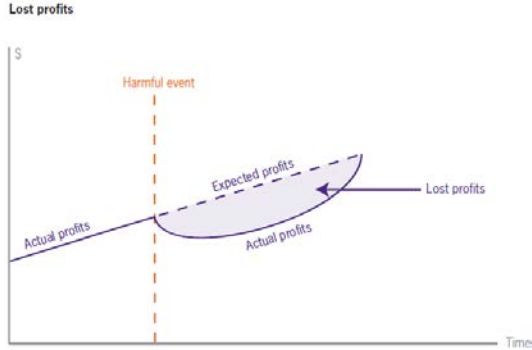
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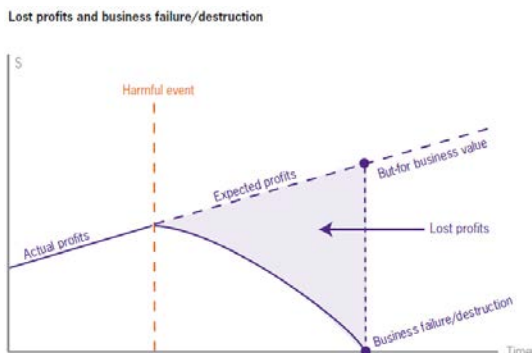
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The lost profits model can be depicted as in the diagram below.



Business valuation and lost profits

If a lost profits analysis is performed, can a business valuation analysis also be performed to measure the total damages owed? It can, as long as doing so will not cause duplicative damages. This damages measure can be calculated as the difference between the but-for expected profits and the actual profits received from the date of the harmful event to the date the business ceased operations, plus the loss of the but-for business value on the date operations ceased, less any salvage value. One might depict this damages method to a trier of fact as in the diagram below.



In making the plaintiff whole, one must consider whether it's plausible that a measurement of damages using lost profits could exceed one using a business valuation. Some say that lost profits cannot exceed business value, whereas others disagree. As

with many things, the answer is that it depends. One can certainly come up with facts and circumstances that cause lost profits to exceed business value. Robert L. Dunn may have summarized it best in his book *Recovery of Damages for Lost Profits* when he said that "if all other things are equal, using the same methodology should produce the same results for lost business value and lost profits. But all other things are rarely equal."¹ The measurement date and the discount rate are two items that cause differences in business valuation and lost profits damages measurements.

	Ex-ante	Ex-post
Measurement date	Date of harm	Date of calculation/trial
Information considered	Information known or knowable at the date of harm, exclusive of subsequent information	All information available
Discounting	Discount all cash flows to the date of harm using an appropriate risk-adjusted discount rate, and apply a prejudgment interest to the date of calculation/trial to bring cash flows to their present value	Discount only future losses to the date of calculation/trial, and apply prejudgment interest to past losses to bring them to their present value

I. Measurement date and the book of wisdom

Background

Business valuation standards outside litigation employ a known-or-knowable concept, requiring a valuation professional to consider only information that is known or knowable as of the valuation date. However, a damages expert may very well consider subsequent information when estimating damages. For example, what are the damages for a stolen \$1 winning lottery ticket if it was stolen after the purchase but before the winning ticket was drawn? Is it worth \$1? Or is it worth the \$100 million prize? This is commonly referred to as the ex-ante versus ex-post debate.

Any one of the differences between the ex-ante and ex-post methods can cause a

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¹ Dunn, Robert L., *Recovery of Damages for Lost Profits*, 6th ed. (Lawpress Corporation, Westport, Conn.), 2005.

significant difference in the damages calculated. Although case law and opinions differ, an expert will generally have an easier time supporting the use of the ex-ante method when a business valuation approach is applied. In light of a Supreme Court opinion commonly referred to as the book of wisdom, an expert will generally find it simpler to support the use of the ex-post method when taking a lost profits approach.

II. Discount rate

Background

The discount rate used in a business valuation involves the overall risks of a company's invested capital (debt and equity), whereas the discount rate in a lost profits calculation may apply only to specific risks. Therefore, discount rates can be, and often are, different for a business valuation than a lost profits damages calculation. High technology and R&D are good examples.

Whether you consider computers or biopharmaceuticals, a stand-alone R&D project will likely have more risk than a portfolio of R&D projects at the same phase of development, all other things being equal. The opposite can be true too. Assume a manufacturing company has multiple clients, many of which have decreasing orders in a declining market and do not have long-term contracts, and one is a client with a long-term contract and increasing purchases. This certainly imposes the likelihood that the long-term contract with the stable client has a lower level of risk than the company overall. Interestingly, though, in a case in the Second Circuit (*Schonfeld v. Hilliard*, 218 F.3d 164 [2nd Cir. 2000]), the court held that "[t]he market value of an income-producing asset is inherently less speculative than lost profits because it is determined at a single point in time.

It represents what a buyer is willing to pay for the chance to earn the speculative profits."

This general statement does not mean that valuation is less speculative than lost profits from an economic perspective in all situations. Clearly, facts and circumstances play a critical role. While there isn't a one-size-fits all standard for litigation purposes, some common practices are used in determining a risk-adjusted discount rate for a lost profits case. The methods or combination of methods, that could be used include:

- the weighted-average cost of capital (WACC);
- equity discount rates;
- debt discount rates;
- lease rates;
- the cost of debt;
- internal rates of return;
- returns on investments of similar businesses or lost profits; and
- conservative, or risk-free, investment returns

However, when one uses business valuation to measure damages, this list becomes shorter, and a traditional discount rate derivation such as the WACC is commonly applied. Each discount rate application may have a theory behind it that applies to a particular set of facts and circumstances, and this theory may lead the expert to select one discount rate over the other.

The bottom line

There are several other differences between business valuation and lost profits damages calculation methods, including the consideration of expenses and taxes. This article did not attempt to articulate them all; rather, it focused on providing a foundation for understanding some of the primary differences between business valuation and lost profits as measurements of economic damages.

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Outsourcing Alert: IRS Publication 179-2015 Puerto Rico Employer's Tax Guide

On March 4, 2015, the Internal Revenue Service (IRS) issued Publication 179, a Spanish version of IRS Publication 15, which is dedicated to Puerto Rico Employers.

This 2015 Federal Tax Guide should be used by employers whose principal business is located in Puerto Rico or who have employees subject to the requirements for withholding, depositing, reporting, paying, and correcting employment taxes. It explains the forms you must give to your employees, those your employees must give to you, and those you must send to the IRS and SSA.

What's new and reminders

Outsourcing payroll duties

Employers are responsible to ensure that tax returns are filed and deposits and payments are made on time, even if the employer contracts a third party to perform these acts. The employer remains responsible if the third party fails to perform any required action.

If you choose to outsource any of your payroll and related tax duties (that is, withholding, reporting, and paying over social security, Medicare, FUTA, and income taxes) with a third-party payer, you must ensure that the third-party contracted complies with their payroll obligations.

Leave-based donation programs to aid victims of the Ebola Virus Disease (EVD) outbreak in Guinea, Liberia, and Sierra Leone

Under these programs, employees may donate their vacation, sick, or personal leave in exchange for employer cash payments made

before January 1, 2016, to a qualified tax-exempt organizations providing relief for the victims of the EVD outbreak in Guinea, Liberia, and Sierra Leone. The donated leave will not be included in the income or wages of the employee. The employer may deduct the cash payments as business expenses or charitable contributions.

Severance payments

Severance payments are subject to social security and Medicare taxes, and FUTA tax. For additional information, please refer to the Tax Guide-Special Rules for Various Types of Services and Payments.

Link

Publication 179 – 2015 Federal Tax Guide for Puerto Rico Employers
<http://www.irs.gov/pub/irs-pdf/p179.pdf>



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