



# Litigation &

V a l u a t i o n

# REPORT

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for less

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accurate  
valuations**

**MORRISON, BROWN, ARGIZ & FARRA, LLP**

*C e r t i f i e d P u b l i c A c c o u n t a n t s*

1001 Brickell Bay Drive, 9th Floor, Miami, FL 33131  
(305) 373-5500 • Fax (305) 373-0056

301 E. Las Olas Boulevard, 5th Floor, Fort Lauderdale, FL 33301  
(954) 760-9000 • Fax (954) 760-4465

1113 Spruce Street, Suite 502, Boulder, CO 80302  
(303) 381-2550 • Fax (303) 381-2551

Website: [www.mba-cpa.com](http://www.mba-cpa.com)

# Don't settle for less

Planning can reduce tax impact of awards and settlements

**T**axes may be the last thing on your mind when preparing for litigation. But a little advance planning can minimize the tax bite on settlement payments or damage awards.

The tax treatment of damages depends on the nature of the underlying claim. Some personal injury damages, for example, are excluded from a plaintiff's taxable income. In employment-related cases, damages attributable to wages are subject to employment taxes, while nonwage damages are not.

## Allocating damages

Many cases involve an amalgam of taxable and nontaxable claims. So an award's or settlement's tax treatment ultimately depends on how the courts — or the parties involved — allocate damages among various claims.

Allocating settlement proceeds is critical. If you don't allocate, the IRS and the courts will do it for you, and the outcome may be different than expected. Of course, simply characterizing a settlement payment in a particular way doesn't make it so. The IRS or a court may recharacterize the proceeds if your allocation isn't reasonable.

## Understanding personal injuries

As originally enacted, Internal Revenue Code Section 104(a)(2) allowed an exclusion from gross income for damages (including settlements) received “on account of personal injuries or sickness.” In cases involving bodily injury, the meaning was clear.

Suppose that George suffers serious neck and back injuries in an auto accident and receives \$1 million in damages for medical expenses and lost wages resulting from his injuries. George also receives \$500,000 for emotional distress, while his wife receives \$250,000 for loss of consortium. All of these damages are generally tax free because they're “on account of” George's personal injuries.

Things become a little murkier, though, in cases involving nonphysical injuries, such as employment discrimination,



defamation and emotional distress. In the early 1990s, the IRS and the courts generally allowed taxpayers to exclude damages based on “tort or tort-type rights,” including employment discrimination. All damages arising out of the discrimination were tax free, including damages for back pay and emotional distress.

But in *Commissioner v. Schleier*, the Supreme Court imposed additional restrictions on Section 104(a)(2). The plaintiff in *Schleier* was an airline pilot fired at age 60 pursuant to company policy. He sued the airline under the Age Discrimination in Employment Act (ADEA) and the parties settled.

## Contrasting injury types

In the *Schleier* settlement, half the settlement proceeds were allocated to back pay, and the other half to liquidated damages. *Schleier* claimed that the entire settlement payment could be excluded from gross income.

The Supreme Court disagreed, holding that even though the case involved tort-type rights, none of the settlement was received “on account of personal injuries or sickness.” The Court contrasted *Schleier*'s back pay settlement with an auto accident case, where damages

for medical expenses, lost wages, pain and suffering, and emotional distress all flow from the accident.

An ADEA settlement is different, the Court said, because neither the plaintiff's 60th birthday nor his termination could be considered a "personal injury" or "sickness." And while Schleier may have suffered intangible injuries comparable to the pain and suffering experienced by an auto accident victim, those injuries didn't cause his lost wages.

### The importance of supporting your case

IRS Technical Advice Memorandum (TAM) 200244004 illustrates the need to support allocations with substantive facts. In TAM 200244004, Employees A and B filed employment discrimination complaints against their former employer, and both settled.

A's settlement agreement allocated half the proceeds to emotional distress damages and half to lost wages. B's agreement allocated one-third of the proceeds to wages and two-thirds to emotional distress.

In accepting A's allocation, the IRS noted that he sought emotional distress damages in his complaint, exhibited symptoms of emotional distress and sought medical treatment. The employer was aware of these facts when it signed the settlement agreement and intended to compensate A for these injuries.

B's complaint, on the other hand, sought only economic damages. Other than a statement in the settlement agreement itself, nothing indicated that B suffered any symptoms of emotional distress or sought treatment. Also, the parties weren't adversaries with respect to the allocation: Both parties stood to benefit by avoiding employment taxes on emotional distress damages.

The IRS concluded that the allocation didn't reflect the settlement's economic substance and ruled that the entire settlement should be characterized as wages subject to employment taxes.

Clearly, to efficiently posture your client's financial position, you need to address tax issues before submitting legal filings.

"In age discrimination," the Court explained, "the discrimination causes both personal injury and loss of wages, but neither is linked to the other." The Court also rejected Schleier's argument that ADEA's liquidated damages provision was intended, at least in part, to compensate plaintiffs for personal injuries that are difficult to quantify. The Court found the liquidated damages to be punitive in nature.

As Justice O'Connor's dissent in *Schleier* recognizes, the Court's decision seems to rely on the unstated assumption that Section 104(a)(2) applies only to *tangible* personal injuries. Otherwise, O'Connor reasoned, employment discrimination damages ought to be covered.

### Getting physical

In an effort to clarify the issue, Congress amended Section 104(a)(2) as part of the Small Business Job Protection Act of 1996 (SBJPA). As amended, the section allows taxpayers to exclude damages received "on account of personal *physical* injuries or *physical* sickness."

SBJPA also provides that punitive damages are generally taxable and that emotional distress is not considered a physical injury, even if it causes physical symptoms. But damages for *medical expenses* related to emotional distress may be excluded.

Unfortunately, there's little guidance on the meaning of "personal physical injuries." Clearly it doesn't include a back pay award for employment discrimination. But what about a sexual harassment case that involves claims of battery or unwanted physical contact?

In a controversial private letter ruling, the IRS considered the taxability of settlement proceeds in a lawsuit charging an employer with sexual harassment, battery and intentional infliction of emotional distress.

The IRS ruled that proceeds allocable to physical contact that didn't produce "observable

bodily harm” were not on account of physical injury or physical sickness and therefore were taxable.

But proceeds allocable to contact that caused observable bodily harm (such as bruises, cuts, swelling and bleeding) were excludable under Section 104(a)(2).

Some commentators have criticized the ruling, maintaining that injuries resulting from invasive, intentional physical abuse should be considered physical whether they’re visible or not.

## Family values

### Divorce valuation and the search for missing income

**M**any valuation approaches and methods exist. But regardless of the road a valuator takes to arrive at a value, the destination is the same: a business’s value, based on its ability to generate income. But what if a business conceals assets or fails to report all its earnings on its financial statements and tax returns?

Missing income is a common problem in divorce cases. If one spouse owns a business, the “nonpropertied” spouse may allege that the business earns more than its financial records suggest. This requires the valuation expert to look behind the numbers and use forensic accounting techniques to search for unreported income.

Valuators use two basic approaches to uncover missing income. One is to search for hidden cash. The other is to identify concealed *sources* of income.

#### Where’s the cash?

Business owners almost always receive unreported income in the form of cash. To avoid detection, the business doesn’t record the income in its books or deposit the cash in its bank account. But experts can use several forensic accounting techniques to prove that cash is missing and estimate how much the owner isn’t reporting.

**Bank deposits method.** The valuator reconstructs income by analyzing bank deposits, canceled checks

#### Controlling damages

Allocating damages or settlement proceeds to personal physical injuries can significantly increase a plaintiff’s after-tax recovery. And even when damages are subject to income tax, allocating a portion to nonwage damages, such as emotional distress, reduces employment tax obligations for both parties.

To be effective, however, the allocation must have economic substance. This means the parties need to think about tax issues in drafting the pleadings and developing their case. □

and currency transactions, accounting for cash payments made from *undeposited* currency receipts as well as nonincome sources of cash — such as loans, gifts, inheritances or insurance proceeds.



**Source and funds application method.** The valuator analyzes the business owner’s personal sources and uses of cash. This method is effective in addressing the question: Where did income and other funds come from, and what were they used for? If the owner is spending more than he or she is taking in, the excess represents unreported income.

**Net worth method.** This method is based on the assumption that an unsubstantiated increase in a

business owner's net worth is attributable to unreported income. The valuator estimates net worth using documents such as bank and brokerage statements, real estate records, and loan or credit card applications.

The expert starts with the amount of gain in net worth, subtracts reported income and adjusts this amount to reflect nondeductible expenditures — such as capital asset acquisitions — and nonincome sources of funds.

**Percentage mark-up method.** The valuator estimates net income by applying a benchmark profit percentage to sales or some other base amount. Valuators usually use this method to corroborate results of other methods.

The IRS routinely uses each of these methods in auditing both businesses and individuals.

#### Where's it coming from?

Even if missing cash is undetectable, a valuator can use forensic accounting techniques to reconstruct unreported income by examining potential sources of that income.

**Example.** Dick and Jane are getting a divorce. Jane suspects that Dick is underreporting income from his soft-drink packaging business, Bottled Up Inc. Jane's valuation consultant discovers that just two distributors supply all the bottle caps Bottled Up uses in its operations.

Jane's lawyer subpoenas the distributors' records, which show how many bottle caps the company purchased during the last three years. The valuator uses this information to reconstruct Bottled Up's sales, which turn out to be 15% higher than the company reported.

#### What's buried here?

Unreported income can be difficult to prove, especially when a business owner is taking active steps to conceal it. But a valuator who knows where to look can dig beneath the surface of a company's financial records and uncover its true value. The techniques described here are just a few examples of the many ways forensic accounting techniques can produce more accurate valuations. □

## Keeping the FLP viable as a planning tool

**T**he family limited partnership (FLP) is a hot topic these days, especially in Tax Court. The IRS continues to challenge FLPs, and hardly a month goes by without a new Tax Court ruling.

After years of rejection in the courts, the IRS has had some recent success against FLPs. This has led some discouraged commentators to predict the FLP's demise as an estate and financial planning tool. But most agree that the FLP remains a viable technique — if it's planned, structured and documented carefully.

#### Carelessness is expensive

Failed FLPs usually involve "bad facts." In most successful IRS challenges, FLPs were disregarded for estate tax purposes because the families failed to treat them as legitimate, discrete businesses.

Families often neglect legal formalities, commingle partnership and personal funds, fail to make periodic

pro-rata distributions to all partners, and use partnership assets for personal expenses. In addition, they may fail to demonstrate that the FLP has any legitimate business purpose apart from reducing taxes.

It's important to remember that an FLP's primary purpose cannot be the avoidance of estate taxes. It must have a legitimate business purpose.

In a recent case, *Mark W. Senda and Michele Senda v. Commissioner*, the taxpayers' careless documentation of partnership transactions cost them almost half a million dollars in federal gift taxes.

#### Timing is everything

The outcome in *Senda* all came down to the timing of key partnership transactions. The Sendas established two FLPs — one in 1998 and one in 1999 — funding them with a total of about \$6 million in MCI WorldCom stock. In each case, the Sendas contributed stock to the partnership and gave limited partnership interests to

their children on the same day. In 2000, they gave their children additional limited partnership interests in the second FLP.

On their gift tax returns for 1998, 1999 and 2000, the Sendas treated the transactions as gifts of limited partnership interests to their children, claiming large valuation discounts from the stock's market value.

But the IRS didn't see it that way. The IRS took the position that the Sendas contributed the stock to the partnerships *after* the children received their limited partnership interests. Under that view, funding the partnerships created indirect gifts of stock to the children,

### Don't neglect the formalities

The Sendas' partnership management and transaction documentation fell short in many ways. For example:

- The partnerships didn't hold annual meetings, prepare annual financial statements, or maintain any books and records other than tax returns and brokerage account statements.
- The Sendas paid all legal and filing fees in connection with the partnerships' formation and were never reimbursed.
- The Sendas didn't prepare and sign certificates of ownership reflecting some transfers until weeks — or even years — after the transfers occurred.
- The children purportedly contributed "oral accounts receivable" in exchange for their partnership interests — but never put those receivables into writing or set up repayment terms. At the time of trial, the receivables were still unpaid.

In addition, Mark Senda's testimony led the court to conclude that the Sendas "were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of the FLPs."

so gift tax should have been assessed on the stock's market value, not on the discounted value of the limited partnership interests.

### A gift is a gift

The IRS drew an analogy between the Sendas' stock transfers and those in *Shepherd v. Commissioner*. In *Shepherd*, the taxpayer transferred stock and real estate to a partnership owned 50% by the taxpayer and 25% each by his two sons.

Under the partnership agreement's terms, contributions were allocated pro rata to each partner's capital account, rather than to the contributing partner's capital account. Because the taxpayer's contribution enhanced the value of his sons' partnership interests, it represented an indirect gift to his sons.

In *Senda*, the court said it was "unclear whether petitioners' contributions of stock were ever reflected in their capital accounts." And there was "no reliable evidence" that the Sendas funded the FLPs *before* they transferred limited partnership interests to their children. "At best," the court said, "the transactions were integrated ... and, in effect, simultaneous." (See "Don't neglect the formalities" on this page.)

Notably, the IRS conceded that the transfers in 2000 were gifts of limited partnership interests rather than stock, and allowed a combined 46% minority and marketability discount.

### FLPs are tricky

*Senda* illustrates the importance of respecting legal formalities and documenting partnership transactions to preserve an FLP's tax benefits. The consequences of failing to do so were particularly severe in this case.

The IRS pointed out that if the transfers had been treated as gifts of limited partnership interests rather than indirect gifts of stock, the Sendas would have been entitled to combined valuation discounts of 39% in 1998 and 45% in 1999. This is good news, because it confirms that a well-planned FLP can still be a powerful planning tool. □

## Team approach yields more accurate valuations

Business valuers don't do their work in a vacuum. Each business interest is different, and its value is affected by many interrelated factors — whether internal or external, financial or nonfinancial, tangible or intangible.

### Beyond the numbers

Valuators must look beyond the company's financial statements to measure the impact on value of such factors as:

- The national and local economies,
- The industry's overall health,
- Management's quality and depth,
- The company's relationships with its customers and suppliers, and
- The company's access to capital.

A valuator assesses each of these factors to determine the level of risk associated with the company. The greater the risk associated with the company, the lower its value — and vice versa.

Valuators also need to develop an understanding of the various legal rights attached to business interests. Liquidation and dividend rights, for example, increase the interest's value. Restrictions on the owner's ability to sell or transfer the interest diminish its value. Attorneys can help valuers produce more accurate valuations by educating them about these rights.



### Teamwork in action

Collaboration between attorneys and valuers is particularly important in identifying rights or restrictions that aren't printed on the stock certificate or other instrument.

Suppose, for example, that an attorney, "A," engages a valuator, "V," to value a 33% interest and a 34% interest in the same closely held corporation in State X. The interests are practically identical, so V's estimates of their value are very close.

What V doesn't realize, however, is that the law in State X permits the holder of a one-third or greater interest in a corporation to compel liquidation under certain circumstances. Had A educated V about these liquidation rights, his valuation of the 34% interest would likely have been significantly higher.

### A bundle of rights

An interest in a business represents a bundle of legal rights and these rights should be considered in the valuation process. Valuers can do this in several ways, including by incorporating rights into projected income streams, adjusting rates of return or applying valuation discounts.

A collaborative approach between attorney and valuator can help ensure that all relevant rights are identified and that the valuation reflects their impact on the interest holder. Business valuations involve a certain degree of subjectivity, so it's important to carefully evaluate and analyze all relevant facts, assumptions and rights.

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– *The Electronic Accountant*, September 2000 –

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### ***Our Business Valuation Team***

Antonio L. Argiz, CPA\*, CVA, ABV, CFE, ASA  
*Managing Partner*

Michael F. O’Rourke, CPA\*, CVA, ABV  
*Partner – Business Valuation and  
Litigation Support Services*

Leroy Koross, CPA\*, CVA  
*Partner – Litigation Support and  
Matrimonial Dissolutions*

Kashyap Bakhai, CPA\*, ABV  
*Partner – Tax Department*

Stuart Rosenberg, CPA\*, ABV  
*Partner – CIS Department*

Viresh Dayal, ABV, CIRA, CFE, CVA  
*Director*

Susan Morrison, CPA\*, ABV  
*Manager*

Poonam Vaidya, CBA, ASA  
*Manager*

Cheryl DaCosta, CPA\*, CVA  
*Senior Accountant*

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