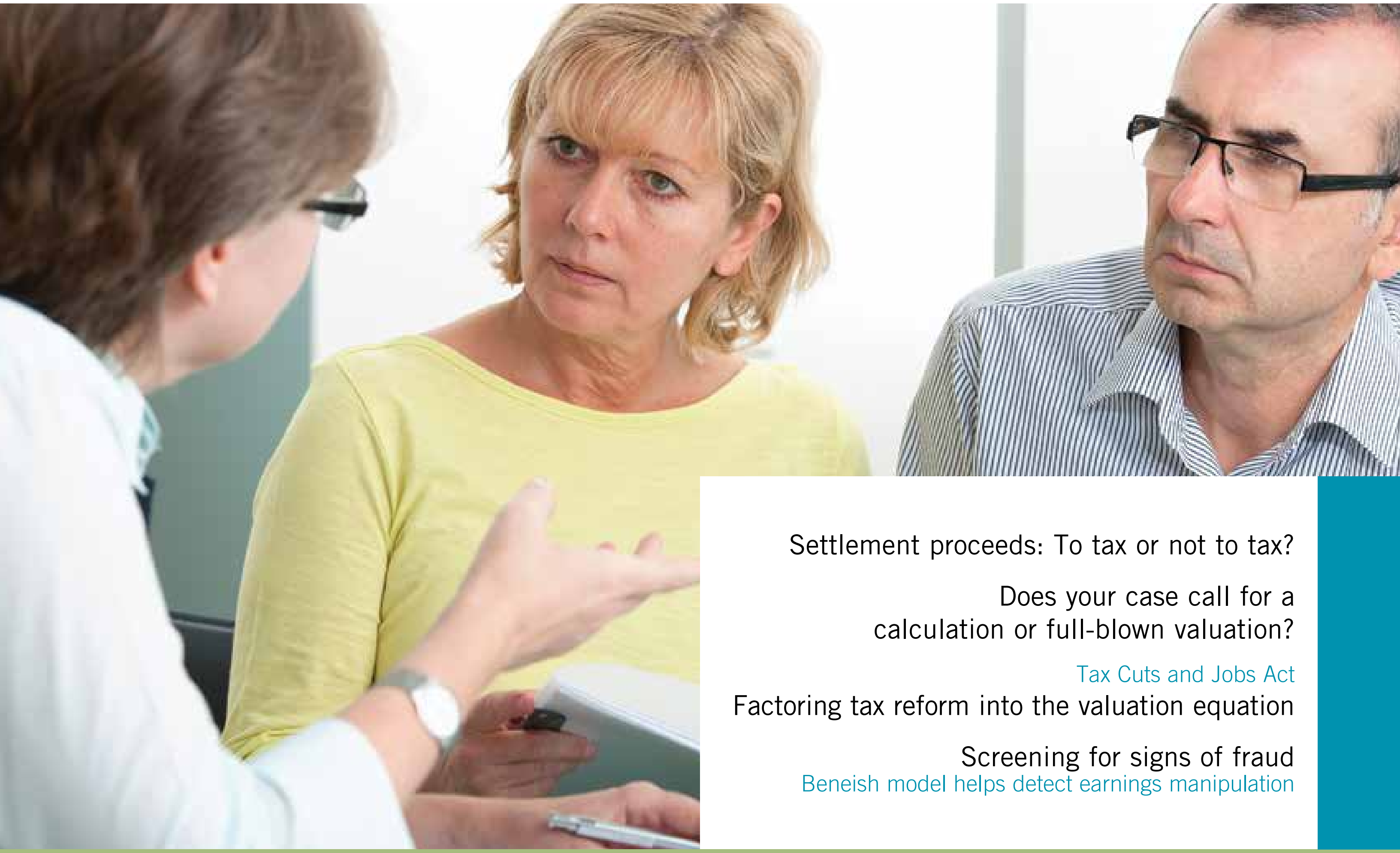
JANUARY/FEBRUARY 2019

ADVOCATE'S EDGE



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Settlement proceeds: To tax or not to tax?

When negotiating a settlement in an employment law case, it's important to consider a wide range of factors. But one factor that employees sometimes overlook during settlement talks is how the language of the settlement agreement can have significant tax consequences, depending on what's included — or not included — in the description of the claims being settled. This lesson was learned the hard way by a former Army employee in a recent U.S. Tax Court case, *Zinger v. Commissioner*.

Case facts

In 2011, the taxpayer worked for the U.S. Army. For a period of two to three months in late 2011, she required frequent physical therapy for a back injury that resulted from a car accident that happened while driving home from work. The employee's supervisor allowed her to use sick time for the therapy visits. That supervisor was reassigned in March 2012.

The employee's new supervisor wasn't aware of the accident or her physical conditions, and he questioned her availability to work. In 2012, the employee and her new supervisor had several conflicts. She felt personally attacked and belittled by the supervisor and began to experience physical symptoms, such as shortness of breath. She sought medical attention, and her doctor recommended several medical leaves.

The employee's medical leave ended in June 2012. When she returned to work on a reduced schedule, she had lost her computer access and security clearance. She sat at a desk with little work.

> Emotional distress isn't treated as a physical injury or physical sickness, except for damages related to the cost of medical care for emotional distress.

The local Equal Employment Opportunity Office (EEO) eventually began an investigation of claims related to sex discrimination and hostile work environment. The EEO's statement of claims didn't refer to any personal physical injuries or physical sickness.

In January 2013, the employee resigned from the Army. She and her employer executed a negotiated agreement to settle the complaint, under which the Army agreed to pay the employee $20,000. She agreed that the agreement constituted "a full and complete settlement of any and all issues and claims arising from" the EEO complaint.

However, the former employee didn't report the settlement proceeds on her 2013 joint federal income tax return. The IRS issued a notice of deficiency, and she appealed.

Language of the settlement agreement

The taxpayer argued that the settlement payment was excludable from gross income under IRC Section 104(4)(2). This provision generally excludes

Primer on taxing damages awards

The IRS has outlined several general rules regarding the taxability of damages:

Damages due to physical injury or physical sickness. Compensatory damages, including lost wages and damages for medical expenses and pain and suffering, are *excludable* from gross income. Damages for emotional distress — even damages for physical symptoms of emotional distress (such as insomnia or headaches) — must be *included* in gross income.

Punitive damages. Punitive damages are *included* in gross income. However, an exception may apply when punitive damages are awarded in a wrongful death case and state law doesn't allow compensatory damages for wrongful death.

Damages for nonphysical injury or sickness. Only actual out-of-pocket medical costs are *excluded* from gross income, assuming the taxpayer hasn't previously deducted the expenses. A taxpayer who receives lawsuit proceeds for a nonphysical injury or sickness claim must *include* in gross income any amount that compensates for an intangible emotional distress value.

Employment-related damages. Damages for economic loss (for example, lost wages, business income and benefits) must be *included* in gross income, unless the loss was caused by personal physical injury.

from gross income nonpunitive damages received by a lawsuit or settlement agreement for personal physical injuries or physical sickness. Emotional distress isn't treated as a physical injury or physical sickness, except for damages related to the cost of medical care for emotional distress.

Thus, when determining whether damages received under a settlement agreement are excludable from gross income, a court considers the nature of the claim settled. The first place the court looks is the settlement agreement. If it doesn't *expressly* state the purpose, courts turn to other evidence of the payer's intent in making the payment, including the amount paid, the factual circumstances that led to the settlement and the allegations in the payee's complaint.

In *Zinger*, the agreement expressly stated that its purpose was to settle the EEO complaint. However, the actual EEO complaint wasn't in evidence. So, the court assumed that the claims in the EEO statement of claims were derived from the EEO complaint. The statement of claims didn't reference any personal physical injuries or physical sickness or allocate the $20,000 payment as compensation for such injuries or sickness.

Rather, it stated that the EEO was investigating whether the taxpayer had been subjected to a hostile work environment or was discriminated against based on her gender. The court, therefore, concluded that the settlement agreement indicated that the Army had intended only to settle the hostile work environment and discrimination claims.

Be direct

It's worth noting that the taxpayer had filed a formal written grievance with her employer that referenced her personal physical sickness. But neither the settlement agreement nor the EEO statement of claims referred to the grievance. To avoid taxation of settlement proceeds, the safest route is to include *explicit* reference to personal physical injuries or physical sickness in the settlement agreement itself.

Does your case call for a calculation or full-blown valuation?

The distinction between value *calculations* and value *conclusions* has received significant attention in the business valuation community over the last year. It's important for your clients to understand the differences to achieve the right level of service from business valuation experts. Calculations can be a less expensive alternative, but they're not right for every case.

Learn the differences

Valuation experts follow different professional standards, depending on the organizations that they're affiliated with. One common source of business valuation standards is the AICPA's Statement on Standards for Valuation Services No. 1 (SSVS 1).

Under SSVS 1, a full *valuation* is performed when an expert 1) is asked to estimate the value of the subject business interest, 2) is free to apply the valuation approaches and methods he or she deems appropriate, and 3) expresses the results of the valuation as a "conclusion of value." This more comprehensive type of engagement is often most appropriate for litigation — including divorce proceedings — and estate and gift tax filings.

Conversely, a *calculation* of value is performed when the expert and client agree on the methods that will be used, as well as the extent of procedures the expert will perform in the process of calculating the value of the business interest. These procedures typically are more limited than those in a full valuation engagement, and the expert expresses the result as a "calculated value."

SSVS 1 explicitly requires experts to state in their calculation reports that they didn't perform all the procedures required for a full valuation. In addition, they may add a disclaimer that, if a full valuation had been performed, the results could have been different. Typically, a calculated value doesn't involve a detailed report. Instead, these engagements might lead to an abbreviated letter report, numerical exhibits or oral presentations.

Sometimes, though, a full valuation isn't necessary or possible, and a calculation of value will suffice — for example, when the expert doesn't have complete access to all relevant information. A calculation of value also could be appropriate for negotiating the sale of a business, facilitating settlements or mediating disputes. Clients may further find a calculation of value useful for strategic planning, including tax and estate planning, and key-person insurance purposes.

Use in limited circumstances

Courts may also accept calculations in some situations. For example, in a recent Alabama divorce case (*Rohling v. Rohling*), the wife's valuation expert presented a calculation to estimate the value of the husband's dental lab.

The husband served as his own expert and argued that his wife's expert conducted the "wrong" type of valuation. The circuit court disagreed, finding that the expert used "methods recognized and accepted by [the] accounting industry for accountants conducting 'calculation engagements.'" Moreover, the fact that a "more arduous or accurate method (valuation engagement)" exists didn't preclude the court's consideration of the expert's findings.

The husband left the circuit court without any credible evidence of value other than the calculation prepared by the wife's expert. The court pointed out that he hadn't hired his own expert — or offered to pay the increased fee to have the wife's expert conduct a more rigorous valuation engagement.

On appeal, the Court of Civil Appeals of Alabama evaluated the differences between valuation and calculation engagements. It found that SSVS 1 approved the use of the capitalization of earnings method (which the wife's expert had applied in his calculation). So, the appeals court affirmed the circuit court decision.

Proceed with caution

Calculation engagements are limited in scope and won't consider any valuation methods beyond those agreed upon with the client. So, they should only be used with caution and may be subject to scrutiny in contentious situations. It's also advisable to consult with applicable state and federal statutes and case law in this regard. There's technically no rule against testifying based on a calculation of value. But beware — courts often prefer a more comprehensive full valuation. ■

Tax Cuts and Jobs Act

Factoring tax reform into the valuation equation

The Tax Cuts and Jobs Act (TCJA) — enacted in late 2017 — will fundamentally alter the tax rules for businesses. While most of the changes affecting businesses are permanent starting in 2018, they're not all favorable. The effects of the TCJA will vary from business to business. But one thing is certain: Valuation professionals will need to evaluate the effects of the changes when they estimate the value of business interests.

How might cash flows increase?

Most businesses and owners are expected to owe *less* federal income taxes under the TCJA than under prior law. Three major changes that will likely increase business cash flows starting in 2018 are:

1. Lower tax rates. C corporations and personal service companies are now subject to a flat 21% federal income tax rate. Under prior law, these entities were subject to graduated tax rates as high as 35%. The corporate alternative minimum tax (AMT) has also been eliminated.

Likewise, pass-through entities (sole proprietorships, partnerships, S corporations and limited liability companies) received a tax cut under the TCJA. In addition to lower individual tax rates, owners of these entities may be eligible for a deduction on qualified business income (QBI) of up to 20%. Eligibility for the QBI deduction depends on the nature of the business and the owner's share of 1) W-2 wages, 2) basis in qualified property, and 3) pass-through income. The QBI deduction is only available through 2025, unless Congress extends it.

The QBI deduction is intended to help achieve tax-rate parity between C corporations and pass-throughs. This provision may cause valuation experts to rethink their position in the so-called “tax-affecting” debate. However, it’s important to note that C corporations are still subject to double taxation under the TCJA — once at the entity level and again when dividends are paid or a sale results in capital gains.

2. Expanded first-year deductions for fixed asset purchases. The Section 179 deduction has increased to $1 million, and the phaseout threshold has increased to $2.5 million. These changes are permanent, and the amounts will be adjusted annually for inflation.

In addition, first-year bonus depreciation on qualifying new and used property increases to 100% for assets placed in service between September 28, 2017, and December 31, 2022. Thereafter, the percentages generally fall to 80% in 2023, 60% in 2024, 40% in 2025, and 20% in 2026. The program expires at the end of 2026, unless Congress extends it.

3. Liberalized tax accounting rules for small businesses. More small businesses (with average annual gross receipts for the three previous tax years of $25 million or less) will qualify for cash-basis accounting rules and simplified inventory reporting methods under the TCJA. These changes could provide opportunities for small businesses to defer future tax obligations.

Which changes are unfavorable to business?

The TCJA includes some provisions that could offset business tax cuts. For example, it establishes new limits on deductions for business entertainment, certain transportation-related employee benefits, interest expense deductions, executive compensation deductions and net operating losses.

The TCJA also repeals like-kind exchanges (except for real estate exchanges) and the Sec. 199 deduction (also known as the manufacturers’ deduction or the domestic production activities deduction). What’s more, companies will be required to capitalize specified research or experimental expenditures, rather than to expense them as incurred, starting in 2022.

Beyond tax cuts

The TCJA is expected to result in sweeping changes as businesses adjust their daily operations and long-term strategies. Experienced valuation professionals must evaluate how tax law changes will affect the expected future earnings and capital structure of each unique subject company. ■

Screening for signs of fraud

Beneish model helps detect earnings manipulation

Financial statement manipulation is the costliest type of occupational fraud. The 2018 *Report to the Nations* published by the Association of Certified Fraud Examiners found that the median loss from financial statement fraud was $800,000, compared to median losses of $114,000 for asset misappropriation and $250,000 for corruption.

With any type of fraud, the sooner it’s detected, the more likely losses can be mitigated. Here’s a tool to help clients quickly assess the likelihood of earnings manipulation.

Model at work

The Beneish model measures the probability that a company’s revenue has been inflated and its expenses have been understated. The model generally computes an "M score" from comparisons between consecutive financial reporting periods of various metrics, including:

- Days sales in receivables (accounts receivables ÷ sales),
- Gross margin [(sales – cost of sales) ÷ sales],
- Asset quality {1 – [(current assets + fixed assets) ÷ total assets]},
- Sales growth,
- Depreciation [depreciation ÷ (fixed assets + depreciation)],
- Sales general and administrative (SG&A) expenses (SG&A expenses ÷ sales),
- Leverage [(current liabilities + long term debt) ÷ total assets], and
- Total accruals (working capital – cash – current taxes payable – depreciation and amortization) to total assets in the current reporting period.

These financial metrics are designed to capture the effects of earnings manipulation or the preconditions that can prompt a company to engage in earnings manipulation. Each metric is weighted using coefficients. For example, the days sales in receivables index has a positive coefficient because disproportionate increases might indicate an overstatement of receivables to artificially boost revenue.

> The Beneish model measures the probability that a company's revenue has been inflated and its expenses have been understated.

Cautionary notes

The economics professor who created the Beneish model admits some important limitations. Notably, the model can't reliably be applied to privately held businesses, because it was developed using public

company data. Additionally, his sample involved manipulation to *over*state earnings. Therefore, the model isn't useful in circumstances where it could prove advantageous to *reduce* earnings — for example, to push revenue into the next quarter to help meet a target for that quarter or to boost revenue prior to a prospective merger.

Some distortions in financial statement data also could have a cause that's unrelated to earnings manipulation. A metric might be distorted by, say, a material acquisition during the period examined, a material shift in the company's strategy for maximizing value or a significant change in the relevant economic environment.

Just a red flag

Because it's relatively easy to use, the Beneish model can be an efficient screening tool for earnings manipulation. But a high M score doesn't prove fraud. Rather, it suggests that further investigation is necessary. Contact a forensic accounting expert for more information.

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