



Advocate's Edge

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November/December 2003

PLUS! Forensic accountants scour "crime scenes"



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Taxing issues surround settlement proceeds

When structuring settlements for clients, experts can help analyze how best to allocate settlement proceeds, figure out the payments, term and related tax consequences and advise how to handle attorneys' fees for tax purposes. After carefully evaluating these areas, your clients may end up farther ahead than any of you initially anticipated. On the other hand, *without* thorough examination, your client may end up saddled with a heavy and unexpected tax burden. The Small Jobs Protection Act of 1996 significantly altered the taxation of personal injury settlement proceeds but, fortunately, didn't diminish opportunities to reduce them. In addition, other opportunities to reduce taxes exist even if the settlement is taxable.

Avoiding the employment tax trap

Internal Revenue Code Section 104(a) excludes from income compensatory damages for actual physical personal injury or sickness. Nevertheless, after 1996, damages related to emotional distress were not eligible for this exclusion unless the emotional distress settlement was compensatory damages for a physical injury. Many wrongful termination settlement agreements now simply allocate all proceeds to wages — subjecting the entire amount to both ordinary income taxes and employment taxes.

Historically, the IRS offers the opportunity to allocate some of the proceeds to categories that aren't subject to employment taxes, which can be as high as 7%. For example, damages resulting from canceling or relinquishing some employment contracts are taxed as ordinary income but not as wages. If the employment contract was for a fixed term and rate of pay, amounts received in connection with contract cancellation are not considered wages. However, the IRS has eliminated this option for contract termination fees outlined in the original employment contract.

The IRS zeroed in on interest or attorneys' fees awarded in employment disputes. Its rulings now state that if interest or attorneys' fees are identified



in the settlement, they won't be considered wages for employment tax purposes. But, if the agreement *doesn't* specify allocation of the settlement proceeds, the entire amount will be considered wages subject to employment taxes.

More nebulous IRS territory surrounds amounts allocated for emotional distress. This type of settlement proceeds could land in the wage column for employment tax purposes. The IRS addressed this topic in Revenue Ruling 96-65, but stopped short of providing a definitive answer. The ruling concluded that compensation for emotional distress caused by unjust denial of a promotion was income and that back pay was includible in gross income as wages. (However, the IRS didn't indicate whether they consider emotional distress damages *themselves* as back pay.) Judging from leanings of previous rulings, emotional distress settlements are taxed as ordinary income but a position exists to exclude it from employment taxes.

Saving taxes with structured settlements

When negotiating settlements, you and your expert should factor in progressive tax rules, which may make after-tax settlements paid piecemeal an

SOME AWARDS CAN BENEFIT FROM CAPITAL GAINS TREATMENT

Recently, long-term capital gains tax rates dipped to 15% while the maximum ordinary income rates are a robust 35%, so settlements that can be treated as long-term capital gains can save your clients a lot in taxes. But when do capital gains rates apply? If an award results from damage to a capital asset and not lost wages or profits, the IRS taxes at capital gains rates any amount exceeding the asset's basis. However, if the underlying claim indicates that the settlement proceeds compensate for lost profits, then the proceeds are includible as ordinary income. To determine the applicability of long- or short-term capital gains rates, look at the damaged asset's holding period. If it's more than 12 months, apply the long-term capital gains rates.

attractive alternative to a lump sum payment. Generally, taxes on settlement proceeds are due the year they're received. This analysis is particularly critical if your client doesn't ordinarily reside in the highest tax bracket.

Assume your client, a married taxpayer, typically has \$20,000 of annual taxable income. And you have agreed to settle an emotional distress (nonphysical injury) lawsuit for \$300,000, which will be taxed at ordinary income rates. On one hand, a lump sum payment of \$300,000 would result in a tax liability of \$87,208 (including the tax on the \$20,000 of regular income). But, on the other hand, \$50,000 of payments spread out over six years would lead to a cumulative tax liability of only \$66,720 (also including tax on the \$20,000 annual regular income). The risk in accepting payouts over six years: uncertain collectibility and income tax rates.

Allocating attorneys' fees

In contingent case settlements, the client typically receives two-thirds and the attorney gets one-third.



But, in most federal jurisdictions, the client is treated as having received the *entire* settlement and is taxed on that total, while receiving a miscellaneous itemized deduction for the attorney's one-third of the proceeds. In essence, the client ends up paying tax on the attorney's fees as well as his or her two-thirds, but reaps little or no benefit from the attorneys' fee deduction because the alternative minimum tax will likely be applicable.

Compensation for emotional distress caused by unjust denial of a promotion was deemed income and thus was includible in gross income as wages.

Then again, depending on which appellate court has jurisdiction over the matter, the client may receive a vastly different result. Currently, the 9th Circuit's view is consistent with that of the IRS. However, the 5th Circuit in *Cotnam v. Commissioner* and the 6th Circuit in *Estate of Clarks v. United States* concluded that the client transferred ownership of that portion of the judgment to the attorney; therefore, the client was only taxed on the net recovery (settlement less attorneys' fees). Because the circuit courts lack consensus, practitioners can't be certain of contingent settlements' tax treatment for their clients.

Calling for assistance

Many tax issues must be addressed when working with clients on structuring settlements. Not adequately addressing these issues could significantly increase a client's tax liability. Please call us; we can offer you guidance on these matters. ✧

How much is enough?

Sufficient relevant data and the litigation process

One person's sufficient may be another's deficient. But, unlike with individuals, courts tend to vacillate less. In fact, "sufficient relevant data" is a basic requirement imposed on accountants before they may render expert opinions.

Daubert v. Merrill Dow applies a similar standard on any expert rendering an opinion in a litigation matter. So, both expert and counsel must examine assumptions. To an extent, your expert needs to rely on the client's expertise or knowledge of facts, and he or she had better perform enough investigation to be sure an independent opinion can be rendered. Here are a few examples that may highlight some of these issues.

Sufficient bases

Let's say you're representing a client in a dispute with his or her insurance carrier, which has denied an employee-bonding claim. You've hired an expert to ascertain the amount stolen by the company's former chief financial officer. The suit alleges that the CFO charged personal vacations to the company's credit cards and covered up the fraud by charging them to travel and entertainment. You give the expert numerous boxes of corporate credit card statements.

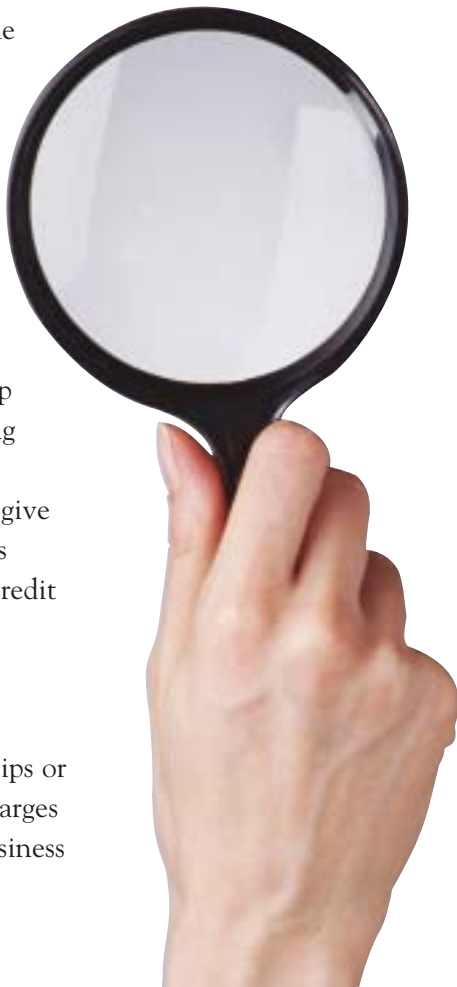
Unfortunately, no one was required to submit the charge slips or indicate why the charges were appropriate business



expenses. The accounting staff just paid the bills — not even accounting was accountable. Now, you're asking the expert to opine that a \$1,500 airline ticket to Washington, D.C., was not for business purposes. Management tells the expert that they don't do business in Washington, so the trip had to be for personal reasons.

How does your expert know that the employee didn't fly there to attend a conference? What about the \$500 dinner at an exclusive restaurant? Management says the CFO was not authorized to spend so much money. But how does the expert know that the CFO didn't take the company's bankers to dinner? Just having details about the payment and an allegation by the company's management shouldn't give the expert a sufficient basis on which to render an opinion that the disbursements were, in fact, fraudulent. Fortunately, to render an opinion, your expert has tools at his or her disposal:

Discovery. Assume you're representing an insurance carrier on a business interruption claim it deems excessive. You receive the claimant's expert's report and subsequently hire your own, asking that he or she prepare a rebuttal report within 30 days. The claimant repairs electric motors and alleges that the



insured lost control of her truck, destroying the front wall of the claimant's building. They allege lost profits (lost sales times gross profit minus incremental operating cost savings) from idle equipment for two months until that portion of the building could be repaired. The company's expert uses a gross margin report from the company's job-costing system as his or her basis.

Your expert reviews the company's tax returns. He or she advises that the tax returns were prepared using the cash basis method of accounting. Your expert decides to use an average gross margin for the last three years that is much lower than what the opposing expert used, hoping to convince the trier of fact that, over a three-year period, the fluctuations will even out. But does your expert have enough basis for this assumption or could his or her opinion be disregarded?

Maybe the claimant's volume significantly increased each year, shooting holes in your expert's theory. Maybe the revenue produced from the idled equipment was different from that of the company as a whole. Perhaps the variations were caused by payment of bonuses or other discretionary income. Effective discovery can help support your expert's presumptions.

Discovery can create the basis for your expert's assumptions. Without it, he or she can be removed.

Assumptions. Let's say you're representing the defendant in a contract dispute. Your client sold his business under an agreement that provided for a three-year earn-out equal to 10% of the increase in annual revenues from then-existing customers. One customer accounted for more than 50% of the business. Six months after the sale, a large public company buys out the major customer.

You hire an expert to determine the unpaid earn-out due to the seller. The expert looks to the sale



agreement for the definition of a "customer" and finds none. You instruct your expert that any sales to the same business and location, even if a different corporation, constitute a "then-existing customer." Your expert gets the customer sales report for the year before the agreement and three years afterward, multiplies the annual increase by 10%, and opines that's the amount due the plaintiff.

Here we go again. What basis does your expert have for your definition of customer? What your expert has done does not seem to be "opinion," rather just mathematics. So, look to get deposition testimony about who the customers' employees are who placed the orders, and paid the bills. Discovery can create the basis. Without it, your expert can be removed.

Relevant answers

An expert's report might lack sufficient basis, rely solely on representations of counsel or client, or be merely a mathematical computation not rising to the level of an expert opinion. Such reports are ripe for a detailed review by your expert to prepare you for a rigorous challenge. Please call so we can help support your challenge, support your client's claims and, if necessary, testify about the validity of our findings. ✧

FORENSIC ACCOUNTANTS SCOUR “CRIME SCENES” FOR EVIDENCE

In the same way forensic scientists deconstruct a crime scene, forensic accountants deconstruct numeric crime scenes, scouring financial statements and other client records for clues and timelines. And, like their gorier criminal counterparts, forensic accountants glean details from trails of alleged malfeasance that can significantly alter a case's outcome.

Slogging through the flotsam and jetsam of documents, forensic accountants can advise or opine about losses (or how to avoid them) or fraud-related issues such as:

- ✓ Reviewing internal controls and assessing strengths and weaknesses,
- ✓ Implementing controls to avoid potential problems,
- ✓ Flagging questionable account balances and transactions,
- ✓ Differentiating between human error and purposeful scams,
- ✓ Charting a company's financial documentation and cash flow,
- ✓ Tracking down and preserving evidence to corroborate asset losses, fraudulent transactions and fraudulent financial statements, and
- ✓ Evaluating managerial and administrative policies and practices to pinpoint potential risks.

When choosing a forensic accountant, you'll want to ensure that he or she has the requisite skills your client or specific case demands. Fortunately, some forensic accountants are multifaceted. For instance, not only can they find the fraud and quantify it, they can also assist counsel in constructing case strategies or creating charts for a case's litigation phase. In addition, they can develop lines of questioning for deposing and cross-examining witnesses and opposing forensic experts. A forensic accountant can help you build a case through various stages of proof.

Get to the bottom of financial statement footnotes

A company's financial statements can help you evaluate its economic well-being, profitability and cash flow. But it's in the footnotes that you often find the most interesting facts. Moreover, as much of an afterthought as they may initially seem, footnotes can contribute greatly to a detailed analysis, whether for valuation or litigation purposes.

In fact, underscoring their importance, footnotes have registered on the government's and accounting board's scrutiny radar. Specifically, recent corporate failures begat the Sarbanes-Oxley Act, and the Financial Accounting Standards Board also beefed up financial statement disclosure requirements. Congress and the SEC now want to require companies to

expand footnote disclosures to help readers better assess company risks and make informed decisions.

It pays to look down

Now that you know that footnotes are an important, and often neglected, repository of key information, here are several hot spots to look for:

Receivables. New accounting standards require companies to disclose their customers' credit terms and policies to establish an allowance for those accounts whose collectibility is in doubt. In addition, footnotes should indicate whether the receivables are pledged as collateral on debt. These disclosures assist readers in evaluating a company's ability to turn

receivables into cash. The ability to turn sales into receivables and receivables into cash is crucial to a business's operations. Footnotes help experts assess management's skill at collecting cash from sales and discern with whom management is doing business.

Guarantees. Many companies will guarantee repayment of bank debt or other liabilities owed by related companies or shareholders. (This, taken to a dishonest extreme, was the source of the Enron scandal.) Businesses used to be required to disclose only the guarantee's amount, but today they must divulge the obligation's amount, terms and collateral as well as the reason for the guarantee and what would happen if the primary obligor defaults on the debt. Footnotes such as these can lead the way to related-party transactions and other potential liabilities, greatly affecting an expert's analysis.

Intangible assets. New accounting pronouncements require companies that have intangible assets such as goodwill on their balance sheets to state these assets at fair value, or what the asset would really be worth at the balance sheet date. Historically, companies recorded the costs that they allocated to these assets and amortized the costs over 40 years.

In that time, no one evaluated whether the book value (cost minus accumulated amortization) could ever be recovered. However, now, if the fair value is less than the book value, companies must write down intangible asset(s) to fair value. The result is a charge to operations in the period ending on that date, instead of an arbitrary write-off of the asset value over 40 years.

Footnotes should discuss a company's rationale for its actions, including its method for valuing intangible assets. This information can help determine whether the company overpaid for its purchase, thereby lowering the purchased company's value to investors.

Derivative financial instruments. These are sometimes lumped together with other off-balance-sheet

items, including transactions such as interest rate swaps. Companies enter into derivative agreements to limit their exposure to large fluctuations in interest rates, foreign currency exchange rates and the like. Businesses must state these transactions at fair value on their financial statements and explain them in detail in the footnotes.

Additionally, companies must unveil the transactions' purpose and nature, as well as their effect on both current-year and cumulative profit or loss. These disclosures can assist experts in evaluating a company's exposure to economic risks and its ability to endure unstable economic times.

Concentrations. On superficial review, a company's financial condition may look rosy, showing high sales and large profit margins, little debt, and strong cash flow. Nevertheless, if all its sales are to only a few customers, the current financial statements may be a misleading guide to the future. Be sure to read the footnotes discussing major customers, industries and other concentrations when analyzing a company's overall well-being and risk tolerance.



Toe the line

Whenever you need to diagnose a company's financial health or predict its performance, financial statement footnotes provide essential information. Be sure to consider them to bring a client's — or the opposition's — financial picture into focus. Should you need help analyzing a company's finances, we're here to assist you. Give us a call. ✧



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