

# ADVOCATE'S EDGE



Do your clients understand the tax treatment of their settlements?

How to value a business in an uncertain marketplace

Using the statement of cash flows to spot fraud

*Rochkind v. Stevenson*  
Maryland gets on board with *Daubert*

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# Do your clients understand the tax treatment of their settlements?

Your clients' elation over receiving healthy settlement amounts for their claims can quickly turn sour when they realize the tax implications. Two recent rulings from the U.S. Tax Court — one involving an employment case and the other involving legal malpractice — serve as valuable reminders that “gross income” is defined broadly. But statutory exclusions, including those for damages, are narrowly construed.

## *Stassi case*

In the employment case, the plaintiff was diagnosed with shingles in February 2014 and had symptoms during her tenure with her employer. On May 21, 2014, she was placed on a 30-day improvement plan. From the next day until her resignation, she was on unpaid leave.

On May 27, 2014, the plaintiff sent a letter to one of her employer's board members, complaining about the work environment. The letter made no reference to physical injury or sickness.

In December 2014, her attorney sent the employer a document demanding wages for wage and hour violations, constructive termination, and “emotional distress and punitives.” A few months later, the parties settled for \$80,000. The settlement agreement referenced, among other things, physical manifestations of emotional distress, although the plaintiff's initial complaint hadn't.

Nonpunitive damages received on account of physical injuries or sickness generally aren't considered gross income for tax purposes.

About \$10,000 of the settlement amount was designated consideration for lost wages, with the remainder designated as consideration for physical manifestations of emotional distress. The employer issued a Form W-2 and a Form 1099-MISC accordingly. The plaintiff reported the wage consideration as taxable wages but reported only \$1 of the balance as “other income.” The IRS determined an income tax deficiency of about \$16,000, and the plaintiff appealed.

The court explained that, under IRC Section 104(a)(2), nonpunitive damages received on account of physical injuries or sickness generally aren't considered



## Return of capital exclusion doesn't apply to malpractice case

In *Blum* (see main article), the plaintiff urged the Tax Court to expand the return of capital exclusion to cover her situation. The court explained that the recovery of capital generally isn't considered income. And it previously held that an amount paid to compensate a taxpayer for a loss suffered due to erroneous advice from a tax consultant is a return of capital and, therefore, excluded from income.

The plaintiff argued that her settlement similarly compensated her for a loss caused by the erroneous advice of her attorneys — the nontaxable amount she would have received if she'd won her personal injury lawsuit. The court, however, wasn't persuaded. For starters, it wasn't convinced she experienced a loss, characterizing the amount she claimed she would have received from the underlying lawsuit as “highly speculative.” The court also noted that her former attorneys had other reasons to settle. It concluded that her settlement didn't restore her capital, rather it provided compensation for her lawyers' failings.

gross income for tax purposes. Emotional distress isn't treated as a physical injury or illness, however. The critical question, therefore, is “in lieu of what were the damages awarded?”

The plaintiff contended that the agreement's inclusion of the words “physical manifestations” established the payments were for physical injury or sickness. But the court found she provided no evidence that showed her shingles were related to or caused by her employment. Because she didn't file a complaint based on physical injury or sickness, and the agreement didn't state that the payment was in lieu of damages for such, no part of the settlement was excludable.

### **Blum case**

Ten days after releasing the *Stassi* decision, the Tax Court issued another opinion dealing with the taxability of settlement proceeds. This case arose out of a medical malpractice claim, where the plaintiff alleged that she suffered injuries after falling from a broken wheelchair that a hospital admissions clerk had directed her to sit in.

The plaintiff lost her medical malpractice case and subsequently brought a malpractice case against her former attorneys. She claimed they breached their duty of care in failing to properly prosecute her lawsuit against the hospital. Her complaint didn't allege

any physical injuries attributable to the attorneys or seek compensation for any physical injuries.

The parties settled for \$125,000, which the plaintiff didn't report to the IRS. She was assessed a deficiency of \$27,418 and turned to the Tax Court for relief. The plaintiff asserted that the payment was excludable because, “but for” the attorneys' allegedly negligent representation, she would have received damages that were excludable.

The court countered that a taxpayer must show a direct causal link between the damages and personal injuries. The settlement agreement, however, made clear that the payment wasn't directly linked to the injuries and that she was being compensated for legal malpractice. For example, it stated that her “physical injuries are ... alleged to have resulted from the ... [hospital] incident, which did *not* occur as a result of any fault or negligence by” the attorneys. Thus, the payment wasn't excludable from income.

### **Leave no doubt**

Your clients' misunderstanding of the proper tax treatment of their settlement proceeds can land them in hot water with the IRS. Make sure they're clear on the law from the outset and that the final settlement language unambiguously reflects the parties' intent regarding the compensation. ■

# How to value a business in an uncertain marketplace

The COVID-19 pandemic has dramatically altered the business world, forcing valuation experts to rethink some of their forecasting models and methods. Here's an overview of how experts approach business valuation assignments differently in today's volatile marketplace.

## What's changed?

The pandemic has had an adverse effect on many operating businesses — but not all. Certain organizations were responsive enough (or possibly just in the right place at the right time) to capitalize on changes in the marketplace.

Examples of businesses that might have prospered in 2020 include:

- Retailers with a strong online presence,
- Homebuilders in the Southeast region of the United States,
- Manufacturers that produce personal protective equipment,
- Professional service firms that quickly pivoted to remote working arrangements, and
- Restaurants that mastered drive-thru, pick-up and delivery models.

Some changes in business operations were only temporary, but others may continue indefinitely.

## How are experts adapting their analyses?

Traditionally, under the market and income approaches, historical financial statements are used to estimate future earnings. However, if a company's performance is expected to differ from previous historical periods, valuers can't necessarily rely on historic data and multipliers.

Short-lived changes may necessitate the use of a more complicated discounted cash flow analysis over a simpler capitalization of earnings method that's based on earnings from a single period. Some changes will continue indefinitely, however. When considering a business's expected cash flows, a valuator must look at current sustainable cash flows instead of historic ones.

Likewise, experts may have to alter their discount rates to reflect today's operating environment. Many businesses are currently experiencing labor shortages, rising prices from suppliers, exposure to cyber-risks, and increased state and federal regulations. Proposed changes to the tax



laws — many of them unfavorable — could also affect the value of a business going forward. Investors generally demand a higher return to compensate for the added risk of operating in an uncertain environment, which decreases value.

### How have the changes affected valuation engagements?

Business owners and attorneys who hire business valuation experts may need to rethink some of their practices, depending on the purpose of the valuation. For instance, the effective valuation date may be critical in estate and gift planning. The assets in an estate typically are valued as of the date of death. However, federal tax law allows an alternative valuation date of six months after death. Using this alternative date may lead to reduced tax liability for estates that include an asset that's declining in value. (Conversely, for estates that are increasing in value, it may be advantageous to use the earlier date.)

In a divorce case, if one spouse has an interest in real estate or a business that has lost value, a nonowner-spouse will receive less when splitting the interest's value. These decreasing values are, in some cases, moving up divorce dates. The owner-spouse wants to act while assets have low values while the nonowner-spouse worries that

values will drop even more. Moreover, some courts are reconsidering divorce settlements if values change unexpectedly and significantly. So, you can't assume a settlement is complete until the final decree is signed and filed.

Likewise, shareholder disputes may be affected by changes in value. For instance, in cases where the wrongdoer's payout will turn on the value of a business, the impact may be strongly felt.

Participants in mergers and acquisitions may also need to adjust to the changing economic landscape. Buyers and sellers might revise their merger plans, incorporate contingent considerations into the terms or factor in timing issues. Previously comparable sales may no longer provide a reliable, apples-to-apples basis for setting a purchase price. The price is more likely to be derived from discounted cash flow techniques that are based on forward-looking financial forecasts, rather than on multiples of historical results.

### Proceed with caution

Until stability returns to the economy, attorneys must exercise extreme caution when it comes to estimating value. Don't just accept a valuation on its face. A value that's accurate today may be inaccurate in only a few months. ■

## Using the statement of cash flows to spot fraud

**F**raud studies show that cash is the most frequently stolen business asset. For example, cash on hand or cash receipts may be taken directly by employees. Or cash may be misappropriated *indirectly* through fraudulent disbursements, such as payroll, billing, expense reimbursement and check tampering schemes.

A company's statement of cash flows shows how cash changed during the year, and it can be analyzed to help detect fraud and financial

misstatement scams. Forensic accountants generally look for amounts that seem unreasonable. They also look for increases or decreases in accounts that seem to contradict trends in operating cash flows or other financial information.

### Focus on cash from operations

The statement of cash flows is typically broken down into three categories: 1) cash from operations, 2) cash from investing activities, and 3) cash from



financing activities. Forensic accountants often apply ratio analysis to detect unusual changes in cash from operations that might indicate fraud.

Examples of amounts to compare to cash from operations include:

- Changes in revenue and income from operations,
- Changes in working capital accounts,
- Asset purchases,
- Dividends paid,
- Current and long-term debt payments, and
- New loan proceeds.

If a company reports an increase in cash flow from operations, it's unlikely to borrow money or seek additional capital from owners. Instead, it's more likely to repay debt or pay dividends.

Not every red flag indicates fraud — but red flags do require further investigation to determine what happened and why.

### Monitor related accounts

Certain accounts tend to have stable relationships over time. That is, an increase in one account generally brings a similar increase in a related account. For example, in many companies, there's a predictable relationship between:

1. Revenue, accounts receivable and inventory,
2. Inventory and accounts payable, and
3. Fixed assets and depreciation expense.

To illustrate, if ABC Company reports a significant increase in revenue in 2021, you'd expect to see a proportionate increase in receivables. Likewise, the company may need to carry more inventory to meet increased customer demand. If the statement of cash flows reveals a *decrease* in either account, it could indicate that the company is reporting fictitious revenue. However, there also could be a reasonable explanation. In this hypothetical case, ABC Company

hired a CFO in January who focused on improving collections and implementing a just-in-time inventory program that significantly reduced the company's investment in working capital.

Not every red flag indicates fraud — but red flags do require further investigation to determine what happened and why. In some cases, red flags may indicate inefficiencies, poor business practices or erroneous accounting practices. Early detection can help mitigate losses.

### Game the statement

When a company is struggling, its statement of cash flows may show a net *decrease* in cash from operations. To make ends meet, the company may generate cash through bank loans, infusions of investor capital and asset sales.

To avoid showing the signs of financial distress, management may artificially boost cash from operations to make the company temporarily *appear* healthier. For example, the company might defer payments to vendors, finance payables or transfer receivables to a variable interest entity to inflate cash from operations. These techniques may qualify as financial misstatement, if the intention is to mislead investors, lenders and other stakeholders to protect or enhance the perpetrator's financial interests.

### Consider outside expertise

The statement of cash flows may provide relevant insight during a fraud investigation. A forensic accounting professional can help analyze this statement for potential red flags and investigate suspicious behavior and financial reporting anomalies. ■



## Rochkind v. Stevenson

# Maryland gets on board with *Daubert*

Maryland's highest court has belatedly joined the majority of jurisdictions in the United States in adopting the 1993 *Daubert* test for determining the admissibility of expert scientific testimony. In doing so, it has abandoned its former "two-channel" approach.

### Out with the old

Previously, Maryland courts admitted expert testimony through the so-called *Frye-Reed* standard and Maryland Rule 5-702. Expert testimony regarding non-novel scientific evidence was required to meet only the requirements of Rule 5-702. Expert testimony on novel scientific theories had to satisfy both requirements.



The *Frye-Reed* standard dictates that admissible testimony must be generally accepted in the relevant scientific community. But, as the high court noted in a tort case involving lead paint exposure, the *Frye-Reed* test over time had implicitly and explicitly relied on and adopted several *Daubert* principles, ultimately becoming a "*Frye-Reed-Plus*" standard.

After a lengthy review of cases that applied the *Frye-Reed* standard, the state supreme court concluded that Maryland's "jurisprudential drift" has produced a duplicative analytical process and muddied the water on how to approach expert testimony. The state supreme court, therefore, opted to implement a single standard by which Maryland courts must evaluate all expert testimony.

### In with not-so-new

The Maryland court's opinion highlights a flaw with the general acceptance test: A generally accepted methodology can produce "bad science" and be

admitted, while a methodology not yet accepted may be excluded, even if it produces "good science." The court ruled that general acceptance should remain an important factor — but not the sole consideration.

The court laid out 10 factors it deems persuasive when determining whether expert testimony is sufficiently reliable. In addition to traditional *Daubert* factors (for example, whether a theory has been tested), courts have developed the following considerations:

- Whether the expert proposes to testify about matters growing naturally and directly out of research he or she has conducted independent of the litigation — or if the opinions were developed specifically for purposes of testifying,
- Whether the expert has unjustifiably extrapolated from an accepted premise to an unfounded conclusion,
- Whether the expert has adequately accounted for obvious alternative explanations,
- Whether the expert is as careful as he or she would be in regular professional work outside of litigation consulting, and
- Whether the claimed field of expertise is known to reach reliable results for the type of proposed opinion.

The court emphasized that no single factor is determinative.

### Dissenting opinion

It's worth noting that the ruling emerged from a 4-3 court. The dissent argued this wasn't the "right case" to make the change and warned that heightened causation requirements are likely to adversely affect those social groups that traditionally have drawn lower research interest and dollars. ■



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