Advocate's EDGE

IRS addresses employment-related settlements and judgments

Gift and estate taxes
Backing up valuation discounts

Theory into practice: Benford's Law finds financial fraud

Reap the benefits of early case assessment

September/October 2010

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CPAs & Forensic Accountants

IRS addresses employment-related settlements and judgments

Employment-related lawsuits have surged in the past decade: According to the Equal Employment Opportunity Commission, the number of discrimination charges filed in 2009 was 20% higher than the number filed in 1999. As attorneys litigate and settle these claims, certain questions related to the taxability of settlements and judgments commonly arise. Tax effects, after all, can shape settlement negotiations and damages claims.

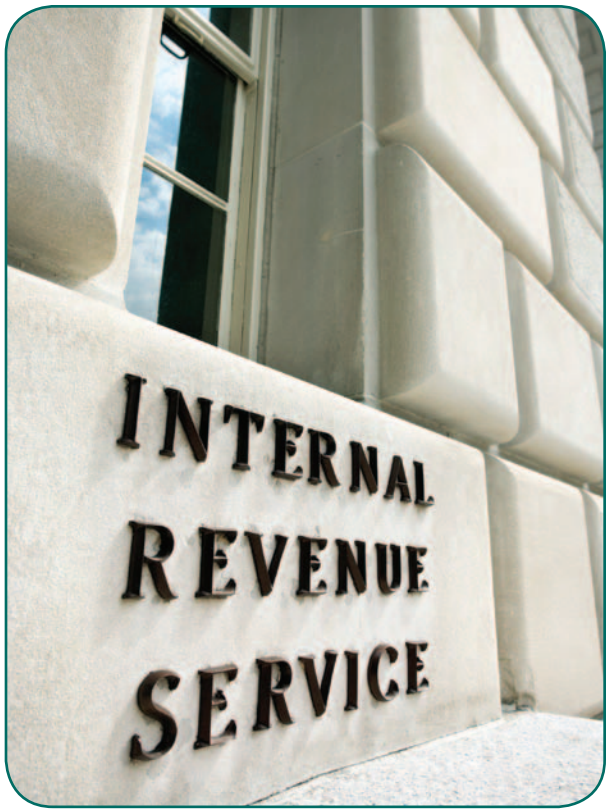
Yet the IRS hasn't provided authoritative guidance. A recent memo released by the agency (PMTA 2009-35) may clarify some matters for both sides in employment disputes, but it also may confuse an issue of particular interest to plaintiffs' attorneys.

THE THRESHOLD QUESTION

Settlements and awards in employment-related lawsuits can include back pay, front pay, severance pay, and compensatory, consequential and punitive damages. But only some of these are subject to taxation.

In the mid-1990s, Congress amended Section 104 of the Internal Revenue Code, largely to address the taxability of proceeds from employment litigation. The section provides that "gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."

Under the related regulations, excludable damages must have been received either through prosecution of a tort lawsuit or in a settlement in lieu of prosecution. Funds received in exchange for a general release as part of a severance package are taxable, as are payments made for emotional distress (except when it's connected with a tort claim for personal physical injuries or physical sickness).



SHEDDING SOME LIGHT

Although Sec. 104 was amended 14 years ago, the IRS still hasn't revised the applicable regulations or released guidance in the form of notices or announcements. This leaves some uncertainty on the income and employment tax consequences of employment-related settlements and judgments.

In 2009, though, the IRS issued PMTA 2009-35, a memo to its employees that explains the agency's position on proper reporting, as well as the income and employment tax consequences of employment-related settlements and judgments. Although the memo has no precedential value, it sheds valuable light on some nagging questions. Specifically, it addresses which payments to plaintiffs are deemed wages for FICA and income tax purposes and, in turn, are subject to withholding.

4 STEP PROCESS

The IRS has indicated that parties to employment-related litigation should determine the components of a settlement or judgment themselves by assessing:

1. The character of the payment and nature of the claim that gave rise to the payment — for example, if the payment is for a lost wages claim brought under Title VII,
2. Whether the payment constitutes an item of gross income,
3. Whether the payment is wages for employment tax purposes, and
4. The appropriate reporting for the payment and any attorneys' fees, such as Form 1099 or Form W-2.

BACK PAY AND ATTORNEYS' FEES

According to PMTA 2009-35, employers must withhold FICA and income taxes on front and severance pay, as well as back pay. The memo reiterates the IRS's "long-standing position" that employment taxes are calculated for the period during which back wages are actually paid, rather than when they *should* have been paid.

The memo also discusses whether attorneys' fees (and interest) recovered in settlement of a claim under a fee-shifting statute are excluded from wages. It describes this as "an open question," implying that defendants may need to withhold employment taxes on attorneys' fees.

Defendants that are unsure whether the portion of a settlement characterized as attorneys' fees is wages are encouraged to contact the IRS National Office for guidance. Of course, regardless of whether attorneys' fees and interest are subject to employment taxes as wages, they are generally includible in the plaintiff's taxable gross income.

ALLOCATION OF FUNDS

The IRS acknowledges that settlements and judgments typically include multiple components — some of which aren't wages. Although court judgments may allocate the final award into its various components (and the memo encourages this practice), the parties to a settlement must ascertain the elements themselves. (See "4 step process" above.)

PMTA 2009-35 notes that, in deciding whether to accept the allocation of damages in a settlement or judgment, it considers: 1) whether there's a bona fide adversarial settlement on the allocation of payment between types of recoveries; and 2) whether the terms are consistent with the true substance of the underlying claims. For example, the Age Discrimination in Employment Act doesn't allow a recovery for emotional distress, so a settlement for such a claim shouldn't allocate funds to emotional distress.

NEWS YOU CAN USE

Although it's not an official position, PMTA 2009-35 can be useful when you're negotiating settlements and building equitable damages cases in court. To ensure you're aware of the latest IRS guidance on the taxability of settlements and judgments, talk with your tax professional.

Gift and estate taxes

Backing up valuation discounts

Gift and estate taxes are a growing concern for many taxpayers as tax legislation seems likely in the near future. Regardless of whether tax rates and exemptions change, valuation discounts probably will continue to play a significant role in the ultimate tax liabilities that taxpayers shoulder.

Establishing the appropriate discounts can prove complicated, though, particularly when dealing with interests that don't have a ready market for sale. What's more, taxpayers must be able to provide sufficient evidence to back such discounts.

LACK OF MARKETABILITY DISCOUNTS

It's easy to calculate the market value of a minority interest in a public company that trades on a widely recognized market — or to cash in such an interest in the market. When dealing with an interest in a closely held business or other relatively illiquid asset, however, valuators must consider a discount for its lack of marketability.

A common hurdle when valuing interests for gift and estate tax purposes is the lack of control an owner may have.

Historically, discounts for lack of marketability (DLOMs) have often been based on restricted stock (which is issued by public companies and subject to SEC restrictions on transferability) and pre-IPO studies. However, many experienced valuators today supplement these studies with more quantitative methods and models, such as the Quantitative Marketability Discount Model and the factors listed by U.S. Tax Court Judge David Laro in *Mandelbaum v. Commissioner*.

PROBLEM WITH STOCK STUDIES

Studies of restricted stock have compared the price of publicly traded unrestricted shares in certain companies with the price of restricted shares in the same companies. The difference is attributed to the restricted shares' lack of marketability. The studies have been interpreted as typically showing DLOMs of 13% to 45%.

The SEC, however, loosened limits on restricted stock in the 1990s, reducing the mandated holding period and expanding the pool of eligible buyers. Some critics argue that older restricted stock studies are outdated and the discounts inflated. Some courts (including the U.S. Tax Court) have agreed. Conversely, many valuators argue that, when valuing shares of private companies, the older studies may be appropriate because their longer holding periods correspond well with those of private companies.

Pre-IPO studies compare the prices of shares of stock before and at the time a company went public. And these studies have found DLOMs of 18% to 59% — even greater than the discount range of restricted stock studies. Although pre-IPO studies have fallen out of favor with some in recent years, other valuators continue to include them in valuation reports — possibly to indicate that their primary method produced a conservative result.

MINORITY AND BUILT-IN GAINS DISCOUNTS

Another common hurdle when valuing interests for gift and estate tax purposes is the lack of control an owner may have over the security. In these cases, valuators may apply a lack-of-control or minority discount.

The amount of the discount for operating companies often is calculated by referencing control premium studies, from which minority discounts can be derived. For holding companies whose underlying assets are marketable securities, the discount often is computed by comparing the price of publicly traded shares in closed-end investment funds with the net asset value (assets less liabilities) per share of those funds.

Valuators working with an entity that holds real estate will likely calculate the minority discount by comparing the price of shares of a sample of real estate investment trusts (REITs) or real estate limited partnerships (RELPs) to the net asset value of the shares. (The Tax Court has indicated that it doesn't have a preference for REIT or RELP data over the other.)

EXPERIENCE MATTERS

There are many other potential discounts a valuator may apply, including built-in gains, key-person and restrictive agreement discounts. But all discounts have one thing in common: They require a close examination of the particular facts and circumstances of the interest at issue with the supporting evidence. Ensure that the values of your clients' holdings survive scrutiny by hiring an experienced, qualified valuation expert.

Theory into practice: Benford's Law finds financial fraud

Benford's Law is a relatively old statistical precept regarding the frequency of certain numbers in random data sets. But only in recent years has it become effective in detecting fraud, thanks to technological advances. Informed by Benford's Law, fraud experts often use spreadsheet software to identify questionable numbers and suspicious activities — spotting possible financial manipulation that would, in many cases, be invisible to the naked eye.

OLD RULE, NEW TRICKS

The rule is named for Frank Benford, a physicist who discovered in the 1930s that, in sets of random data, multidigit numbers beginning with 1, 2 or 3 are more likely to occur than those starting with 4 through 9. Studies have determined that numbers beginning with 1 will occur about 30% of the time, and numbers beginning with 2 will appear about

18% of the time. Those beginning with 9 should occur less than 5% of the time.

Further, these probabilities have been described as both "scale invariant" and "base invariant," meaning the numbers involved could be based on, for example, the prices of stocks in either dollars or yen. As long as the set includes at least four numbers, the first digit of a number is more likely to be 1 than any other single-digit number.

RANDOM'S TOUGH TO REPLICATE

Benford's Law carries striking implications for fraud detection. To avoid raising suspicion, fraud perpetrators often use figures they believe will replicate randomness. Typically, they choose a relatively equal distribution of numbers beginning with 1 through 9 in the mistaken belief that all nine digits are equally probable.

Fraud investigators can take advantage of such errors and test data in a variety of financial documents. These include tax returns, inventory records, expense reports, accounts payable or receivable, general ledgers, and refund reports. Although complicated software programs based on Benford's Law exist to examine massive amounts of data, the principle is simple enough to apply using spreadsheet programs such as Microsoft Excel®.

Indeed, anyone with Excel can analyze random groups of numbers by determining the distribution of the first digits of those numbers by building a table with rows for each digit (1-9) and columns for the:

1. Frequency with which numbers beginning with each digit occur in the random sample,
2. Percentage rate of that frequency, and
3. Percentage rate of the frequency to expect according to Benford's Law.

In sets of random data, multidigit numbers beginning with 1, 2 or 3 are more likely to occur than those starting with 4 through 9.

Excel can easily convert the table into a chart that graphically illustrates any significant discrepancies between the actual and expected occurrence of the first digits. A chart that shows too many numbers beginning with 9 and too few with 1 should raise red flags and prompt further investigation.

EXCEPTIONS TO THE RULE

Benford's Law, however, isn't infallible. The law may not work in cases that involve:

- Smaller sets of numbers that don't follow the rules of randomness,
- Numbers that have been rounded, resulting in different first digits,
- Prices, where 95 and 99 turn up regularly because of marketing strategies,
- Numbers that are assigned, such as those on invoices, or
- Uniform distributions, such as lotteries where every number painted on a ball has an equal likelihood of selection.

The principle also may be ineffective for sets of numbers with built-in ceilings and floors. For example, expense reports where receipts are required for meals costing $25 or more will reveal many claims just under the limit, in amounts such as $24.90.

HERE TODAY, HERE TOMORROW

Although faking realistic financial data isn't impossible, it's beyond the abilities of most occupational fraud perpetrators. Benford's Law, therefore, is likely to remain an essential weapon in the war against fraud for some time to come.

Reap the benefits of early case assessment

Most businesses these days are watching their expenses — including legal expenses — carefully. You can help clients manage their litigation costs, particularly those related to e-discovery, with early case assessments (ECAs).

PROACTIVE CASE EVALUATION

"ECA" is an umbrella term that covers various types of assessments that range in breadth and depth based on the client and type of case. However, almost all ECAs involve proactive case evaluation early in the litigation process. This includes such activities as:

- Reviewing case facts,
- Creating a fact timeline,
- Collecting key documents,
- Analyzing data,
- Researching case law, and
- Reviewing client interviews.

More advanced ECAs might use such tools as social networking analysis to determine who communicates with whom and about what. Such analysis, for example, can help attorneys identify information custodians and implement effective litigation holds.

Further, documents might be searched using keywords and key concepts, data ranges and custodians, with an eye toward identifying those most likely to be relevant and responsive. Review of these documents can reveal the critical terms and topics in the matter, which may provide an upper hand during mandatory meet-and-confer meetings.

FACILITATING COST SAVINGS

ECA helps facilitate cost savings by allowing the culling of documents that are clearly irrelevant and nonresponsive early in the process — thereby reducing the number of documents that must be reviewed closely. It also aids strategic planning by providing guidance on how to allocate resources. And, by loosely quantifying the amount of electronically stored information (ESI) subject to discovery, ECA can pave the way to more accurate budgeting. Finally, it can help attorneys and their clients decide whether to proceed with litigation or settle.

Research conducted in 2007 on behalf of LexisNexis found that, when ECA is performed, cases tend to be resolved favorably, with reduced litigation expenses. Attorneys familiar with ECA also report that it's useful for strategic planning and budget management.

The LexisNexis study found that most attorneys who've used ECA do so informally. But a qualified forensic expert can help you achieve the best results by developing a specific methodology and set of tools.

FISCAL RESPONSIBILITY

It may seem counterintuitive for an attorney to advise performing an ECA that, ultimately, could limit his or her role in a case. But, consider this: Clients that know their attorney is fiscally conscious are more likely to be satisfied and return with other legal matters.