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# BCC Advisers Litigation & Valuation REPORT

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# In litigation, a little tax planning pays off

The economic impact of a settlement or damages award depends on whether it's taxable to the plaintiff and deductible by the defendant. A tax-free \$1 million judgment, for example, is substantially more valuable to a plaintiff than one that comes with a \$400,000 tax bill. And from a defendant's perspective, the ability to deduct a damages payment takes some of the sting out of a loss. By incorporating tax strategies into the litigation planning process, you can help your clients improve their chances of a tax-beneficial outcome.

## How are damages taxed?

Generally, a plaintiff's recovery of damages is taxable unless a specific exception applies. In addition to income taxes, damages that represent wages, such as back pay in employment discrimination cases, are also subject to FICA and other employment taxes.

One exception is an award that produces no gain for a plaintiff. This might include an award that reimburses a plaintiff for nondeductible expenses or for damage

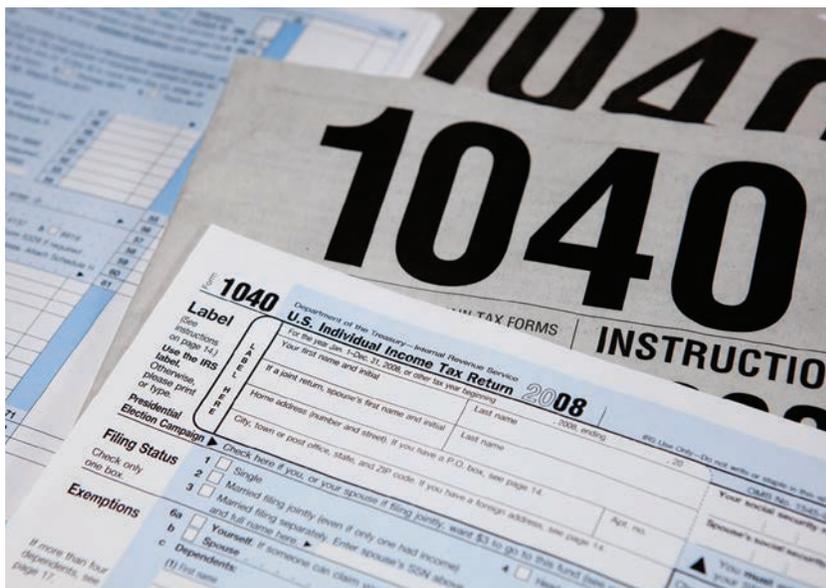
to, or destruction of, a capital asset, such as real property or stock. In the case of a capital asset, damages are tax-free up to the plaintiff's adjusted basis in the property. To the extent that damages exceed the plaintiff's basis, they're taxable as capital gains.

*In some cases, defendants are required to capitalize damages payments and recover their costs through depreciation or amortization.*

Another exception is compensation for injuries or sickness excludable from income under Internal Revenue Code Section 104. This includes compensatory damages received "on account of personal physical injuries or physical sickness" under Sec. 104(a)(2). The application of Sec. 104(a)(2) is straightforward in cases involving bodily injury.

Suppose, for example, that Martha is seriously injured in a car accident caused by the defendant's negligence, and recovers damages for medical expenses, pain and suffering, lost wages and emotional distress. Arguably, all of these damages, which flow from the original bodily injury, are tax-free because they're "on account of personal physical injuries."

Things get more complicated in cases involving nonphysical injuries that result in physical injury or physical sickness. Employment discrimination cases, for example, often have a



## DEDUCTIBILITY OF DAMAGES IN FCA CASES

In a 2014 case — *Fresenius Medical Care Holdings Inc.* — the U.S. Court of Appeals for the First Circuit opened the door to greater deductibility of damages in False Claims Act (FCA) settlements, upholding a defendant's \$50 million refund claim. The defendant argued that a significant portion of double damages paid to the government were compensatory rather than punitive in nature and, therefore, deductible. Departing from an earlier Ninth Circuit case, the First Circuit held that a court may consider factors beyond the mere presence or absence of a tax characterization agreement between the parties in determining whether settlement payments are deductible.

To improve their chances of a tax-beneficial outcome, defendants in FCA cases should document their settlement discussions with the government and gather evidence that demonstrates the compensatory nature of damages.



significant emotional distress component that may lead to serious physical illness. But Sec. 104 expressly states that emotional distress shall not be treated as a physical injury or physical sickness (except for medical expenses).

The IRS and courts generally don't apply this exclusion to damages attributable to emotional distress *symptoms*, such as migraines, nausea or insomnia. But some courts have held that damages for emotional distress are tax-free when it causes more serious physical harm, such as a heart attack or nerve damage, and the plaintiff's condition is supported by a medical diagnosis and testimony.

### When are damages deductible?

The deductibility of a defendant's payment of damages doesn't depend on whether they are includable in the plaintiff's income, but it generally follows the same rules that govern the deductibility of other expenses. For example, damages that constitute "ordinary and necessary business expenses" are deductible, while payments associated with personal litigation are not. A deduction is not available for punitive damages, fines and penalties, or statutory treble damages.

In some cases, defendants are required to capitalize, rather than deduct, damages payments and recover their costs through depreciation or amortization.

For example, in litigation involving the breach of a contract to acquire a capital asset, the defendant may have to add its litigation costs to the property's basis.

### Laying the foundation

Tax planning early in a case can help lay the foundation for a beneficial tax outcome. Many cases involve a combination of taxable and nontaxable (or deductible and nondeductible) claims, so the tax treatment of a judgment or settlement depends on how it's allocated among those claims. Whether damages are allocated by the court or by the parties in their settlement agreement, the allocation must have economic substance.

For example, suppose Martha and her employer settle an employment discrimination claim for \$1 million and the settlement agreement allocates \$200,000 to back pay and the remaining \$800,000 to serious physical injury caused by emotional distress. A court is unlikely to uphold this allocation unless Martha emphasized physical injuries in her complaint or in correspondence with her employer, received medical treatment for those injuries and offered medical evidence in support of her claim.

### Best economic outcome

When formulating litigation strategies, taxes may not be your top priority. But considering taxes early in a case can help you achieve the best economic outcome for your client. ♦

## *Bross Trucking Inc. v. Commissioner*

# Determining the value of personal goodwill

**P**ersonal goodwill in business valuation is alive and well, as a 2014 U.S. Tax Court case, *Bross Trucking Inc. v. Commissioner*, demonstrates. The court concluded that virtually all goodwill associated with Bross Trucking belonged to its owner. As a result, he didn't receive goodwill from the corporation or make a gift of those assets to his three sons, who formed a new trucking company.

### **Business vs. personal**

Goodwill is an intangible asset derived from such factors as a business's name, reputation, customer loyalty, location and products. Typically, its value is represented by a business's excess fair market value over the value of its net tangible assets and identifiable intangible assets (such as patents, trademarks and other intellectual property).

*In merger and acquisition transactions, allocating a portion of the purchase price to personal goodwill offers important tax advantages.*

Valuators often make a distinction between personal goodwill and business goodwill. The former is derived from an individual owner's reputation, training, skills, experience and relationships. In contrast, the latter reflects characteristics of the business itself (apart from its owners), including its name, reputation, location, products and workforce in place. These attributes remain with the company even if a key owner leaves.

The distinction between business and personal goodwill is critical in several valuation contexts.



In divorce cases, for example, some states treat personal goodwill as the separate property of the spouse who owns the business, while others treat it as a marital asset subject to division. And in merger and acquisition transactions, allocating a portion of the purchase price to personal goodwill offers important tax advantages. For instance, personal goodwill can be purchased directly from the individual owners, avoiding corporate-level taxes.

### **New company is formed**

Starting in the late 1960s, the owner of Bross Trucking created and built several family-owned road construction businesses, all of which depended on his talents and personal relationships for their success. In 1982, he, as sole owner, established Bross Trucking to haul materials for the family businesses (and to haul coal in the winter for other customers). The company leased most of its equipment from another Bross family business and used independent contractors to drive the trucks.

In the 1990s, various safety issues caused the company's reputation with regulators to suffer, and Bross Trucking faced possible suspension. To avoid hurting

its construction businesses, the owner's sons formed a new trucking company, LWK Trucking.

### Antithesis of goodwill

The IRS characterized these events as a distribution of goodwill from Bross Trucking to its sole shareholder, triggering corporate-level income taxes, followed by a taxable gift of that goodwill to his sons. The Tax Court disagreed, finding the company's poor reputation and potential suspension to be "the antithesis of goodwill." What goodwill did exist (apart from a small workforce in place) was the owner's separate property and, therefore, was not the company's to distribute. The court also emphasized that the owner hadn't transferred any goodwill to the company by signing an employment or noncompete agreement.

Several factors supported the conclusion that the owner didn't transfer goodwill to his sons. His sons

went out of their way to downplay their relationship with Bross Trucking and create their own goodwill.

For example, LWK acquired its own insurance and independently satisfied all regulatory requirements, rather than switching over Bross Trucking's insurance and licenses. And although LWK leased the same trucks from the same related entity, it went out of its way to cover the Bross brand with its own name and logo. LWK also offered services beyond what Bross Trucking had offered and hired only about half of Bross Trucking's employees.

### Lessons learned

*Bross Trucking* confirms that personal goodwill is a viable asset, distinct from business goodwill. It can be transferred (or, in this case, retained) separately from business goodwill, depending on the facts and circumstances. ♦

## What's normal?

### The ins and outs of valuation adjustments

To create an accurate picture of a company's finances, a valuator likely will need to make various adjustments to "normalize" earnings. These adjustments may include removing unusual events from the company's financial statements and adjusting the company's historical results for discretionary spending.

But determining what's normal isn't necessarily easy. It involves detailed analysis, as well as an understanding of the company's current and future operations, to help ensure the numbers more accurately reflect how much hypothetical investors can expect to earn.

### Income stream revisions

When applying the income or market approach, an appraiser derives a company's value from its earnings using capitalization (or discount) rates or pricing

multiples, respectively. But before jumping headfirst into this basic math, he or she asks whether a company's past earnings represent its future earnings potential to a hypothetical buyer. If it doesn't, the valuator considers revising the company's income stream to better reflect the future cash flow a prospective buyer could generate from its operations.

Discretionary adjustments are the first subset of income stream adjustments. These modifications are intended to bring a company's expenses in line with industry norms. Discretionary costs that commonly require adjustment include owners compensation and perks and related-party transactions.

In addition to changing the expenses the current owner controls, the valuator asks whether the historic

income stream includes any unusual or nonrecurring expenses, such as startup costs or legal fees associated with a pending lawsuit. Because these items aren't expected to continue in the future and thus have no value to a potential buyer, the valuator removes them from the company's earnings.

### Last-minute changes

After a valuator makes a preliminary estimate of a company's value, he or she considers additional fine-tuning. Before finalizing the conclusion, the valuator assesses exactly what the preliminary value estimate includes. If anything is missing, the valuator makes a last-minute alteration.

Common last-minute alterations include changes to excess or deficit working capital (compared with the company's normal operating needs), contingent or unrecorded assets and liabilities, nonoperating assets, and real estate (if most industry participants rent their facilities).

### Discount adjustments

Among the most common valuation discounts are minority interest and lack of marketability. Minority interest discounts reduce an interest's value to reflect its inability to control the company's management and policies. When quantifying this discount, a valuator considers several factors — such as levels of control and associated benefits, whether the appraiser revised the company's income stream for discretionary items, distribution of the other shares, and contractual agreements among the owners.

On the other hand, lack-of-marketability discounts reflect the relative difficulty (in terms of liquidity, time and transaction costs) an investor in a private company would have selling his or her shares. Factors that affect an interest's marketability include size of the subject business interest, transfer restrictions, dividend-paying policy and financial performance.

The flip side of discounts is valuation premiums. Rather than reduce a company's value, premiums increase its value. The two most common are the control premium and the swing vote premium. The former is the mathematical inverse of the minority interest discount, and



it's designed to increase a minority basis value to a controlling basis value, considering the economic value of benefits to be recognized through the elements of control. The control premium is especially relevant in merger-and-acquisition valuations.

A swing vote premium reflects the ability of a minority shareholder to side with another owner to affect decision-making. For instance, a 2% interest might be subject to this premium if two other individuals equally owned the remaining shares.

### A more accurate picture

Because a valuation adjustment requires a valuator to use his or her professional expertise and experience, it may become contentious between parties and even lead to a lawsuit. Business owners and attorneys can prevent this outcome by understanding the reasoning behind valuation adjustments and how valutors use them to create a more accurate financial picture. ♦

# Important reminder: HIPAA extends to expert witnesses

**H**ealth issues arise in a variety of litigation contexts, including personal injury, medical malpractice, divorce and insurance claims. In these cases, attorneys need to take precautions to ensure that they — and their expert witnesses and consultants — comply with the Health Insurance Portability and Accountability Act of 1996 (HIPAA).

## What the act does

The act requires “covered entities,” such as health plans, health care clearinghouses and health care providers that transmit health information electronically, to safeguard and limit disclosure of patients’ protected health information (PHI) and to implement specific data security measures.

In 2009, the Health Information Technology for Economic and Clinical Health (HITECH) Act extended many of HIPAA’s provisions — including its data security rule — to the “business associates” of covered entities. Business associates include lawyers and law firms whose work for a covered entity involves access to PHI. They also include subcontractors, such as expert witnesses or consultants, who create, receive, maintain or transmit PHI on behalf of another business associate.

Business associates are required to sign an agreement that, among other things, mandates compliance with HIPAA’s privacy and data security rules. Under these rules, a business associate must implement:

- ◆ Administrative safeguards, such as security awareness and training, workforce security, and backup procedures,
- ◆ Physical safeguards, such as controlling access to facilities or to individual workstations, and
- ◆ Technical safeguards, such as user identification, encryption, automatic logoff and other access controls.

For each of these requirements, the rule provides specifications and other implementation guidance.

## Handle with care

Attorneys often give their expert witnesses or consultants everything they have — a “data dump” — and leave it to the expert to sift through the documents and identify relevant materials.

But when a HIPAA-covered entity is involved, the expert may inadvertently gain access to PHI. If this information isn’t relevant to the expert’s work, the attorney may violate HIPAA’s privacy rule that limits disclosures of PHI to the minimum necessary for the intended purpose.

To avoid running afoul of HIPAA, take steps to avoid disclosure of PHI to experts unless the information is relevant to the expert’s engagement. If disclosure of PHI is necessary, the expert should sign a business associate agreement and implement measures to protect PHI.

## Get help

HIPAA’s privacy and data security rules are complex. If you’re uncertain about your obligations in connection with litigation, be sure to consult health care counsel. ◆



# Valuations



Whether you are buying or selling, settling a legal dispute or securing financing, determining the value of your business for any reason involves many complicated factors. Since 1992, BCC Advisers has handled hundreds of valuations.

We know the art and science of the valuation process and use the most resourceful methods to establish an objective fair market value for your business. Our consultants are individually accredited by one or more of the major appraisal organizations and use a comprehensive and thorough approach that minimizes intrusions on your day-to-day operations.

# Litigation Support



BCC Advisers' valuation consultants have been called upon as experts in hundreds of litigation cases by both plaintiffs and defendants. Our valuation professionals can serve as witnesses and/or consultants for your case. Using our financial experience and insight, we handle multiple

aspects of case preparation, leaving the attorney free to focus on the intricacies of the law. With our depth of business knowledge, the litigation team will have the added power needed for your success.



*By serving as your source of fundamental strength, BCC Advisers helps you, in turn, find your own true strength. We cut through the gray areas of valuation and litigation support with concrete solutions that end in successful results. Results that our clients and their professional advisers can be proud of. When you require valuation or litigation support, please give us a call.*



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