NOVEMBER/DECEMBER 2023

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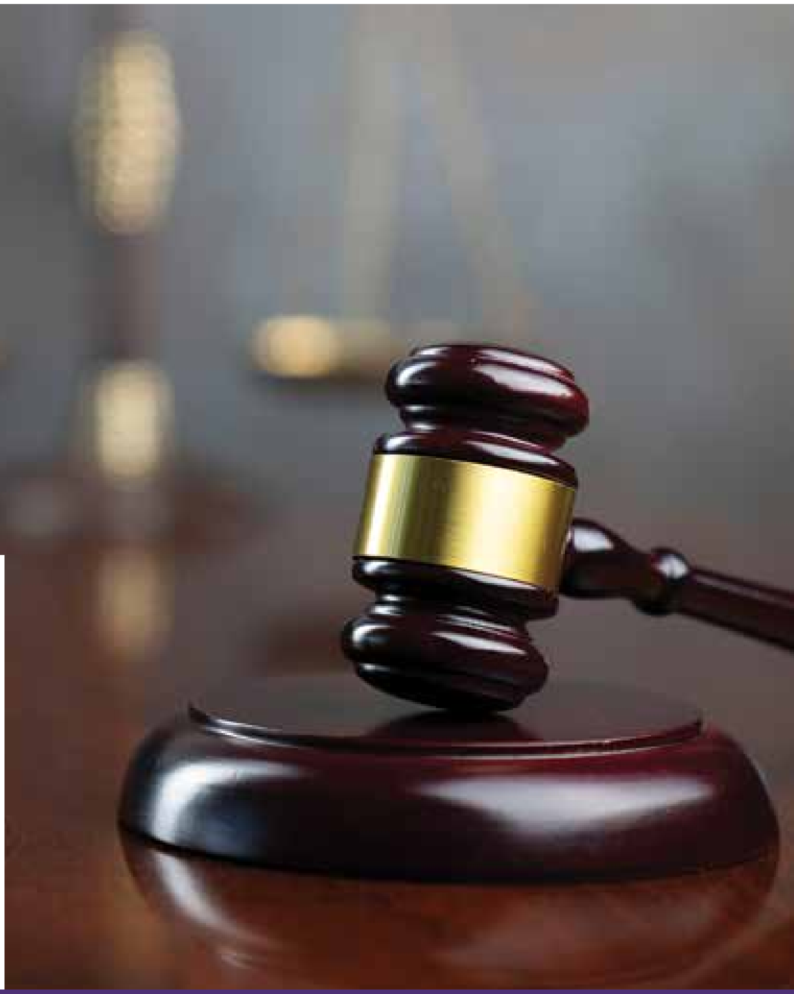

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Estate of MacElhenny v. Commissioner

Claims against decedent didn't reduce the estate's value

The U.S. Tax Court recently ruled that an estate couldn't deduct the value of two consent judgments entered against the decedent. Here's a summary of why the U.S. Tax Court sided with the IRS, ruling that the judgments didn't qualify as "bona fide" claims against the estate.

Developer provides financial power of attorney

The decedent sold and developed real estate. He continued to manage some properties for several years after giving his two children (a son and a daughter) financial power of attorney for him in 2004.

By early 2012, the decedent was severely incapacitated, and his son took over his business affairs. The son soon discovered that his father was in a "troubled financial state." Among the most pressing issues were two short-term debts.

Decedent's debts

The first debt involved a breach-of-contract judgment Union Bank had obtained against a limited partnership in which the decedent had an interest, its general partner and the decedent individually. When the decedent was unable to make a payment on this judgment, his son purchased the judgment against him. The daughter subsequently obtained a 50% interest in the judgment. A state court determined that each sibling had a 50% interest in a $6-million judgment, accruing 10% interest annually.

The second debt involved Westamerica Bank. It held two loans, one personally guaranteed by the decedent and another guaranteed by his wholly owned entity. Westamerica Bank sued after defaults on both loans, and the parties stipulated a judgment of roughly $1.46 million. The son eventually purchased that judgment for $865,517, also accruing 10% interest annually.

The father died in 2015 and his son and daughter, as co-executors of his estate, filed an estate tax return in 2016. The return claimed deductions of approximately $3.64 million and $1 million attributable to the remaining values of the Union Bank and Westamerica Bank judgments, respectively. The IRS disallowed the deductions and issued a notice of tax deficiency of almost $4 million. Because both judgments involved family members, the IRS determined they weren't bona fide debts and, therefore, weren't deductible. The estate turned to the U.S. Tax Court for relief.

State court's entry doesn't make judgments "bona fide" claims

In *Estate of MacElhenny* (see main article) the co-executors argued that the assigned bank judgments were bona fide debts and, therefore, deductible, because a state court had entered the judgments. The U.S. Tax Court rejected this notion.

Under the tax regulations, a final judicial decision can establish the amount of a claim that's otherwise deductible from an estate. But the Tax Court pointed out that the regulations require that the court actually "pass upon the facts" on which deductibility depends.

Here, the state court that entered these judgments didn't consider whether the claims continued to be the decedent's personal obligations after the payments were made. Because it didn't "pass upon the facts," the Tax Court declined to rely upon its entries as evidence that the assigned claims were bona fide.

Deductibility arguments

Tax regulations provide that a claim against an estate that's founded on a promise or agreement is deductible only to the extent that the claim is "contracted bona fide and for an adequate and full consideration in money or money's worth." The requirement aims to prevent deductions of claims that are actually gifts or testamentary dispositions.

The IRS argued that the bank judgments weren't bona fide claims against the estate, primarily because the decedent's children satisfied the debts when they transferred money to the bank in exchange for the purported assignments of the judgments. It further asserted that, upon the decedent's death, the debts were no longer his personal obligations.

Heightened scrutiny for family members

The Tax Court sided with the IRS. It emphasized that, because the claims and assignment of claims involved family members, a heightened level of scrutiny must be applied in the analysis of their validity. It found the co-executors didn't meet their burden of proving that the debts were still their father's personal obligations at his death because they satisfied the debts before he died.

The court acknowledged that when the banks sued the decedent for breach of contract the claims represented his personal obligations. But once his children settled those debts, the decedent was no longer personally obligated to make payments toward the judgments. Assigning the judgments to the children didn't change this.

The assignments weren't made in the ordinary course of business, nor did they result from arm's-length negotiations. Settling the claims via cash payment was an ordinary business transaction, but the assignment wasn't. Further, the son was on both sides of the transactions during negotiations. That is, he agreed on the decedent's behalf to have the judgments entered against the decedent and in favor of himself and his sister.

Deficiency upheld

Notably, the Tax Court stressed that the estate itself didn't pay any money toward the claims. Although the children contended that the estate would satisfy the amounts remaining once the tax case was resolved, they hadn't taken any previous actions to collect. Without "any reasonable certainty of payment," the court found the claims wouldn't be deductible anyway. ■

FAQs about valuing human capital

The term "human capital" refers to a trained and assembled group of workers who know how to operate equipment, follow the company's policies and procedures, innovate to build new products and services, and work together as a team to achieve the company's strategic goals. Human capital is often an unreported — but valuable — asset that can be difficult to appraise.

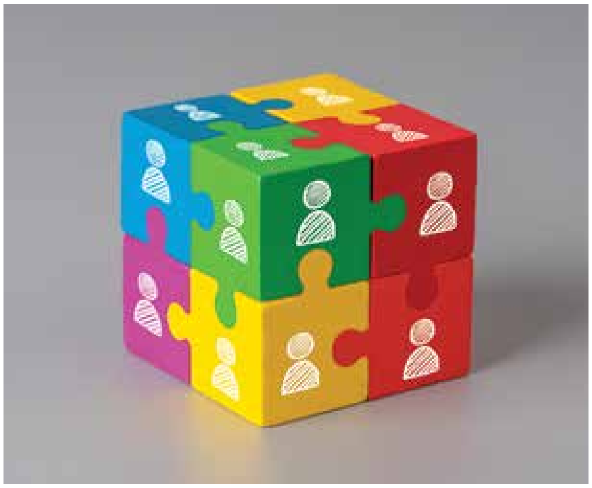
What is human capital?

Human capital comes in many forms. The most obvious example is employees on the company's payroll. But it also may include relationships with independent contractors, consultants and celebrities, as well as employment contracts, noncompetes and confidentiality agreements.

Professional licenses may be considered another type of human capital because they allow professional services firms to conduct business and, therefore, add value. But these licenses can't be transferred to third parties and are typically the property of individual practitioners, not companies.

How is human capital valued?

Human capital generally isn't reported on companies' balance sheets under U.S. Generally Accepted Accounting Principles. However, most



established businesses have developed this asset over the years.

A logical starting point for valuing an assembled workforce is to estimate the cost to reproduce or replace the company's workers. This estimate includes the costs to recruit, hire and train each level of the company's workforce. Valuators consider such items as headhunter fees; compensation expenses of recruitment and training staff; costs of background checks, drug tests and screening exams; and relocation fees, moving costs and signing bonuses.

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When valuing workforce assets, an important distinction should be made between reproduction and replacement cost. Reproduction cost is the current cost of an *identical* property — in other words, the same number of employees with the same skills, education levels, experience and salary requirements. Replacement cost is the current cost of employing a *similar* workforce that has the nearest equivalent utility to the existing workforce. Replacements might be younger employees who are willing to perform the work for less money — or fewer employees who are more highly qualified and efficient — than the existing workforce.

When are the income or market approaches used?

Although the cost approach is the most common way to value an assembled workforce, the income or market approaches are sometimes used to gauge whether the results of the cost approach make sense. For example, the value of a professional practice's workforce under the cost approach could be divided by the number of employees to calculate the average value per employee. This amount could then be compared to the average net realizable billable hours per employee to impute the firm's return on human capital.

Assembled workforces aren't normally sold as separate assets. So the market approach is rarely used to value human capital. But a valuation professional might compute the value of a workforce under the cost approach as a percentage of the company's total value and ask whether a buyer would be willing to pay a certain amount to acquire the assets or whether a seller would be willing to give up the assets for a certain amount.

Why do businesses need to value human capital?

There are several situations that call for human capital-related assets to be separately valued. In mergers and acquisitions, the value of human capital is relevant when establishing the selling price. An assembled workforce that's been acquired is also an amortizable intangible asset for federal income tax purposes. Litigation involving alleged violations of contractual obligations — such as the terms of employment contracts, noncompetes or celebrity endorsement agreements — also may warrant damages calculations based on the value of human capital-related intangibles.

In addition, the value of an assembled workforce may be used to identify business goodwill in states that bifurcate business and personal goodwill when splitting up marital estates in divorce cases. Or it may be needed to lower a company's property tax base, where intangibles are excluded from ad valorem property tax assessments.

Putting a price tag on people

In many industries, human capital is key to a successful business. A valuation professional can provide objective market data and financial analysis to help support a workforce appraisal. ■

How to reduce frauds from C-suite executives

The largest occupational fraud losses typically come from people in positions with the highest authority — owners and executives. The median loss from these fraud schemes is $337,000, compared to $50,000 for rank-and-file workers, according to the *Occupational Fraud 2022: A Report to the Nations*. This biennial report, published by the Association of Certified Fraud Examiners (ACFE), also reveals that roughly 23% of frauds are committed by executives, including owners, CEOs and CFOs. Companies and nonprofits may be able to thwart executive-level frauds by focusing on the three critical elements of the fraud triangle.

1. Motive

First, perpetrators must experience some type of pressure that motivates them to commit fraud. Pressure can come from within organizations — for example, pressure to meet aggressive earnings or growth targets. Alternatively, pressure could be personal, such as the need to maintain a high standard of living or pay off debt from credit cards, medical bills or gambling.

Executives tend to feel "lifestyle" pressures. For example, they might need to drive an expensive car to prove they've "made it." Or they might feel pressure to pump up revenue or profits to impress investors or lenders.

To minimize pressures to commit fraud, it's important to compensate executives fairly and set realistic performance goals. Employee Assistance Programs (EAPs) that provide counseling and other help to troubled employees can also relieve pressures, especially when employees are dealing with addictions or family crises.

2. Opportunity

Executives have unique opportunities to commit fraud that aren't available to lower-level employees. Their positions of authority may allow them to bully or intimidate subordinates and override controls that would otherwise detect fraud. These factors can make it harder to detect executive crimes, causing such frauds to incur higher losses and last longer. In fact, the ACFE reports that the median duration of frauds committed by an owner or executive is 18 months, compared to just eight months for rank-and-file employees.

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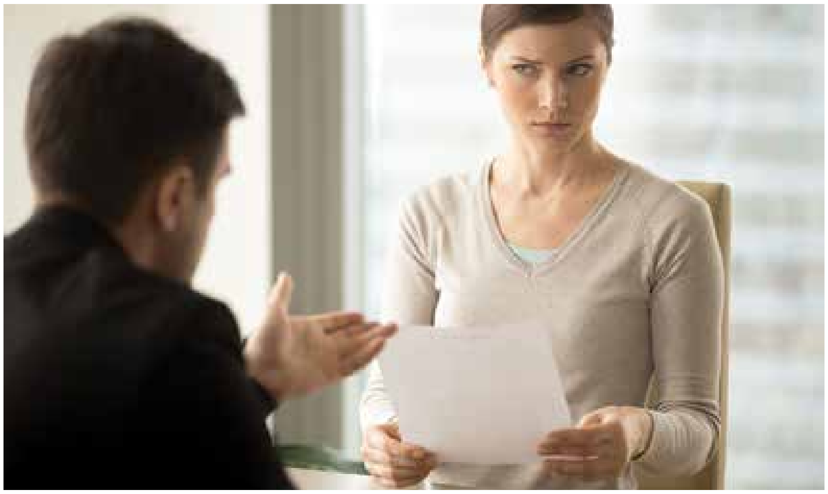
A strong system of internal controls is a company's first line of defense against executive fraud. Effective measures may include whistleblower reporting hotlines, fraud training programs and audits. It's important that executives *perceive* that someone (such as an internal or external auditor) is overseeing their work — and that suspicious behaviors will be reported and investigated.

3. Rationalization

The third leg of the fraud triangle is a perpetrator's ability to justify dishonest behavior. When perpetrators rationalize wrongdoing, they overcome ethical barriers that generally guide their conduct. For example, they might tell themselves that they'll pay back the money before anyone misses it. They may reason their employers can afford financial losses — or that they'll lose *everything* if they don't commit fraud.



Changing a would-be fraudster's mindset can be challenging, especially when substance or gambling addictions are clouding someone's thinking. Organizations may be able to get inside a perpetrator's head by communicating zero-tolerance antifraud policies and providing tangible consequences for dishonest behaviors, such as termination, probation, criminal referrals and civil actions. Fostering a supportive workplace — rather than a cut-throat, win-at-all-costs culture — can also make it harder for executives to rationalize dishonest behaviors.

Risk assessment

All organizations should conduct risk assessments to identify the areas where they're most vulnerable to fraud perpetrated by C-suite executives. Forensic accounting experts can perform independent assessments and recommend corrective measures, as well as investigate suspicious behaviors to detect frauds early and minimize potential losses. ■

Beware of the corporate opportunity doctrine

A New York trial court in *O'Mahony v. Whiston* recently found the majority owners of a successful sports bar misappropriated a "corporate opportunity" when they used lease buyout proceeds to relocate the bar and start a new corporation to run it. The court also expressed some harsh words toward the parties' expert witnesses.

Bar redux

The case was principally a derivative action regarding the rights of the corporation that operated a previous bar (Dubcork), rather than those of the minority owners. The action arose when a dispute with the bar's landlord led to a lucrative lease buyout and the bar reopened a few blocks from its original spot.

According to the court, credible evidence established that the new location was essentially the same bar — with the same name, theme and core clientele. "Abundant evidence" showed this was just what the defendant majority owners intended, and they lied to the plaintiff minority owners about what was happening with the buyout proceeds. They used Dubcork's assets to open the new bar under a new corporation, thereby misappropriating a corporate opportunity of Dubcork and effectively cutting out the plaintiffs.

Under the corporate opportunity doctrine, an agent of a corporation can't divert or exploit for the agent's own benefit an opportunity that's the principal's opportunity. An agent also can't make use of the principal's resources or proprietary information to organize a competing business.

The court found that the original bar had a "tangible expectancy" of owning the relocated version of its bar, which was presented to the public as a continuation of the original bar. Further, the lease buyout proceeds were enough to have given Dubcork the opportunity to own the new bar.

Expert issues

Turning to damages, the court found the defense expert unpersuasive for multiple reasons. For example, he made definitive assertions on disputed issues and frequently failed to cite record evidence to support those assertions. He also proffered opinions on contested issues that were subsequently disproven and "recklessly" speculated on matters about which he was unfamiliar.

The plaintiffs' expert wasn't immune from criticism either. For instance, the court found his revenue projections "too rosy" given the pandemic's effect on the hospitality industry in New York City. Weaknesses in his testimony prompted the court to take a "conservative approach" to forecasting the new bar's prospects.

Bottom line

The court ultimately awarded damages of $2.82 million, including $733,728 in disgorgement. It also assessed $100,000 in punitive damages against each of the three majority owners. More persuasive expert testimony might have produced different results. ■

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