

The Expert

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Splitting charitable remainder trusts in divorce

What are the tax consequences?

While the division of some marital assets in divorce can seem straightforward, questions have arisen about making a pro rata, 50-50 division of a charitable remainder trust (CRT) into two trusts for the spouses. In response, the IRS issued Revenue Ruling 2008-41, which addresses the tax consequences of such a division.

The scenario

In its ruling, the IRS considered a trust that qualifies as a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT). Under the trust's terms, the spouse recipients are each entitled to an equal share of the annuity or unitrust amount, payable annually during their lifetimes.

CRATs and CRUTs generally are subject to Section 507(a) of the Internal Revenue Code as if they were private foundations.

Upon the death of one, the surviving recipient is entitled for life to the entire annuity or unitrust amount. And when the survivor dies, the trust assets will be distributed to one or more charitable organizations.

As part of the property division at divorce, the court approves a pro rata division of the trust into two separate trusts, each intended to qualify as the same type of CRT. Each asset of the original trust is divided equally and transferred to the separate trusts. Each separate trust is then deemed to have an equal share of the original trust's



income, and each recipient is entitled to receive from his or her separate trust the same annuity or unitrust amount as under the terms of the original trust. The recipients pay all of the costs associated with the division of the trust.

Each separate trust provides that, upon the recipient's death, the trust terminates and its assets are distributed to the remainder beneficiary charities. Each spouse relinquishes all interests in the original trust to which he or she would have been entitled by reason of having survived the other.

Private foundation excise taxes

CRATs and CRUTs qualify as "split-interest trusts" that generally are subject to Section 507(a) of the Internal Revenue Code (IRC) as if they were private foundations. The provision imposes a termination or excise tax when a private foundation's tax status is terminated. But does the transfer of assets from a private foundation (or CRT) to another private foundation (or CRT) trigger the tax?

Revenue Ruling 2008-41 notes that, in the case of such a transfer pursuant to an “adjustment, organization or reorganization” that “includes a significant disposition of assets,” the transferee foundation isn’t treated as a newly created organization and the excise tax doesn’t apply. A “significant disposition of assets” includes the transfer of a total of 25% or more of the fair market value (FMV) of the net assets of the original private foundation to one or more private foundations. In the scenario above, 100% of the FMV would be transferred. Thus, no excise tax applies.

Self-dealing excise taxes

Split-interest trusts like CRATs and CRUTs are also subject to IRC Sec. 4941(a)(1). This provision imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation.

The XYZ of CRTs and nonmarried recipients

Revenue Ruling 2008-41 also confirmed that a charitable remainder trust (CRT) might be divided into separate trusts for multiple — but nonmarried — income recipients without triggering adverse tax consequences.

The ruling described a situation where the terms of a charitable remainder unitrust (CRUT) entitle X, Y and Z to share equally the annual payments of a 15% unitrust amount while all are living. When one recipient dies, the surviving recipients are entitled to the deceased’s share.

Upon division of the CRUT, three separate trusts are created, each holding one-third of the original trust’s assets. Each recipient is entitled to annual payments of a 15% unitrust amount from his or her separate trust. When X dies, each asset of X’s separate trust is divided on a pro rata basis and transferred to Y’s and Z’s separate trusts.

Y and Z each remain entitled to annual payments of a 15% unitrust amount from their separate trusts, each of which is now funded with the equivalent of one-half of the original trust’s assets. And no excise taxes are incurred.

Self-dealing includes any direct or indirect transfer of the income or assets of a private foundation to a disqualified person. It also includes use of such income or assets by — or for the benefit of — a disqualified person. Disqualified persons include, among others:

- ◆ Substantial contributors to the foundation,
- ◆ Foundation managers, and
- ◆ Members of the family of a substantial contributor or foundation manager.

The IRS observed in Revenue Ruling 2008-41 that the divorcing spouses in the above scenario might be disqualified persons with respect to the original trust, creating the potential for self-dealing. But it concluded that the spouse recipients are insulated from self-dealing with respect to their interests upon the trust’s division. Because of the pro rata distributions, neither spouse will receive any additional interest in the original trust’s assets, no self-dealing transaction occurs and the original trust’s remainder interest is preserved exclusively for charitable interests.

Taxable expenditures excise tax

Sec. 4945 of the IRC imposes an excise tax on each taxable expenditure made by a private foundation such as a CRAT or CRUT. In Revenue Ruling 2008-41, though, the IRS determined that the pro rata division of a CRT into two or more trusts does not constitute a taxable expenditure under Sec. 4945.

The labor of division

Revenue Ruling 2008-41 makes it clear that separate trusts, if the original CRT is properly divided, generally will qualify as CRTs. The requisite 50-50 split might prove difficult with some assets, though, such as certain pieces of real estate.

A qualified financial expert can help spouses and their attorneys craft a sustainable division of readily divisible assets and determine the most advantageous method for handling less divisible assets. ◆

The value of a workforce

Appraisal of human capital often necessary, complex

Figuratively speaking, you can't put a value on your company's employees. But, from a valuation perspective, you can — and, in some cases, you may have to. But what are the circumstances that would prompt the appraisal of a workforce? And how would an appraiser go about estimating the dollar value of a business's employees? Let's take an in-depth look at both questions.

Many purposes

Determining the value of a company's assembled workforce might be necessary for many purposes. Among the most common is financial reporting. A company's workforce isn't treated as a separate asset for the purpose of accounting for business combinations, but it may be relevant for certain other financial reporting purposes such as determining appropriate "capital charges" when valuing other intangible assets or supporting goodwill value.

Another cue for a human capital appraisal is pricing and structuring a business sale or merger. A trained and assembled workforce may be a critical component of value to a prospective buyer or merger partner — particularly in industries where employees require highly specialized skills.

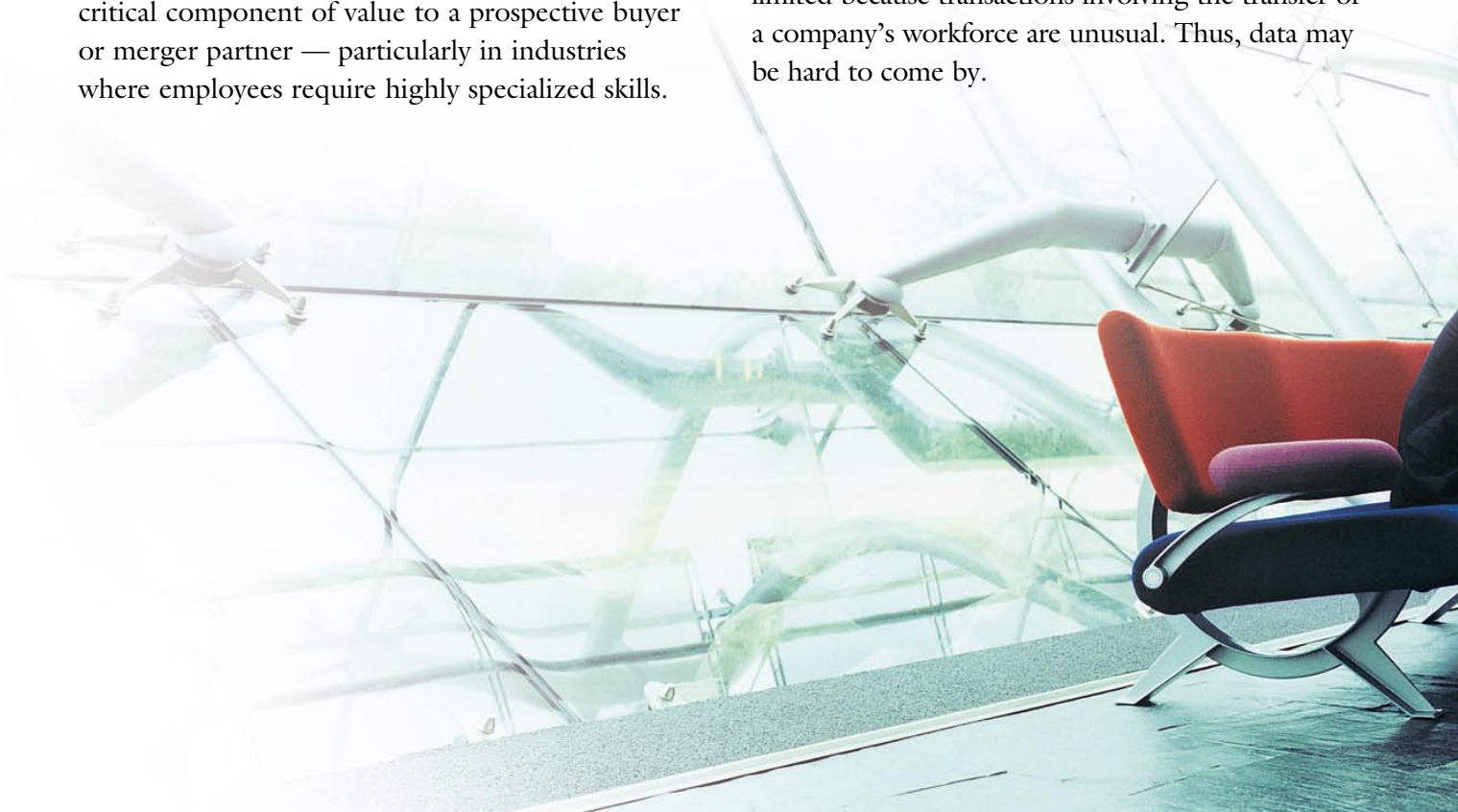
Income or property taxes may also prompt an appraisal of this kind. For federal income tax purposes, an assembled workforce acquired in a taxable transaction is an amortizable intangible asset. And, in many states, the value of a company's assembled workforce and other intangible assets can be excluded from its property tax base.

The value of an assembled workforce may be relevant in a litigation setting, too. For example, an appraisal may be necessary to calculate damages an employee or former employee has caused by breaching an employment or noncompete agreement.

A variety of approaches

Like most assets, whether tangible or intangible, an assembled workforce may be valued using one or more of the three basic valuation approaches.

First, there's the market approach. Here an appraiser examines actual market transactions involving comparable companies. But the usefulness of this approach in valuing an assembled workforce may be limited because transactions involving the transfer of a company's workforce are unusual. Thus, data may be hard to come by.



Another option is the income approach, under which the appraiser measures the present value of future economic benefits (such as cash flows or earnings). The income approach may be particularly suitable for professional firms and other service businesses where it's possible to measure the income specific employees or groups of employees generate. By the same token, this approach may be less appropriate for manufacturers or other capital-intensive businesses.

Probably the most common way to estimate the value of an assembled workforce is the cost approach. The appraiser calculates the recruiting, hiring and training costs associated with the subject company's workforce and estimates the investment that would be required to duplicate it.

The valuator may estimate the "reproduction cost," which is the cost of creating an exact duplicate of the existing workforce. Alternatively, he or she may measure the "replacement cost," which is the cost of creating a workforce capable of matching the existing workforce's output.

Replacement cost may hypothesize a workforce that looks different from the current one. For instance, it may posit a smaller number of employees with superior skills. Under this method, the valuator makes adjustments to reflect differences in labor costs and other factors.

When using the cost approach, appraisers consider characteristics of the existing workforce that affect value. For example, if the current workforce includes many highly compensated, long-time employees, it may be appropriate to reduce its value to reflect the possibility of re-creating the workforce with equally skilled but lower paid younger employees.

More prevalent

The rough economy has brought an uptick in the number of layoffs and furloughs. And when such events occur, the estimated value of the affected workforce can change. Thus, appraisals of this nature are becoming more and more prevalent. ♦



Research shows bankruptcy drives financial statement fraud

The rough economy is pushing an increasing number of businesses into bankruptcy. And, according to recent research, financial statement fraud may be more prevalent in companies that file for bankruptcy.

Specifically, financial analysts Deloitte analyzed bankruptcy filings in 2000 through 2005, as well as Securities and Exchange Commission (SEC) enforcement releases for 2000 through 2007. It found that bankrupt companies were three times more likely than nonbankrupt ones to receive financial statement fraud enforcement releases from the SEC. What's more, companies that received financial statement fraud enforcement releases were more than twice as likely to file for bankruptcy.

Chief characteristics

Financial statement fraud is the intentional misrepresentation or omission of material information from an organization's financial reports. It often involves the reporting of fictitious revenues or concealment of expenses or liabilities to make an organization appear more profitable than it truly is. Deloitte found that revenue recognition was the most common fraud issue for both bankrupt and nonbankrupt companies issued enforcement releases by the SEC.

In a recent survey of occupational fraud, the Association of Certified Fraud Examiners (ACFE) found that financial statement fraud was by far the most costly category (when compared with asset misappropriation and corruption), with a median loss of \$2 million.

The ACFE notes that losses from financial statement fraud differ from corruption or misappropriation schemes. The losses frequently reflect lost market capitalization or lost shareholder value rather than the direct loss of financial assets.

The ACFE study also identified certain red flags for financial statement fraud in organizations. Excessive organizational pressure to perform was a particularly strong warning sign. Perhaps this explains why more than 70% of the financial statement frauds in the study were perpetrated by individuals in the executive suite or accounting department. Control issues and a "wheeler-dealer attitude" are also common in the perpetrators.

Effect of SOX controls

The ACFE survey also examined the effect of Sarbanes-Oxley (SOX) controls on the cases of financial statement fraud in its study. Surprisingly, it found that the presence of the controls didn't correlate with a decrease in the median loss for financial statement fraud schemes.

In fact, for all controls other than fraud-reporting hotlines, organizations with SOX controls in place experienced greater fraudulent financial statement manipulations than organizations without the controls.

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On the lookout

With bankruptcy on the rise, it seems likely that financial statement fraud will come into play in much of the related litigation. Business owners and their attorneys should be on the lookout for these schemes and work with their financial advisors to detect any that may be in progress. ♦

ATTORNEY-CLIENT PRIVILEGE NOT GUARANTEED

Attorney-client privilege is a cornerstone of our legal system. Yet business owners and their counsel shouldn't take attorney-client privilege for granted — especially when sharing information with third-party experts such as appraisers, accountants and forensic specialists.

Although effective representation hinges on open, confidential communication between attorneys and their clients, attorney-client privilege isn't guaranteed. It can be waived for many reasons, one of which was brought to light in the recent New York Supreme Court case of *Sieger v. Zak*.

Information, please

In this minority shareholder suit for fraud and breach of fiduciary duty, the plaintiffs, two minority shareholders, wanted access to documents the corporation, Powersystems International (PSI) and its majority shareholder and CEO, Louis Zak, shared with an appraiser.

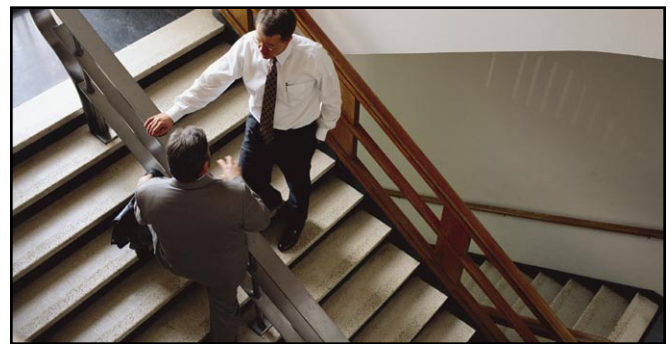
The subpoenaed information included communications between the appraiser and corporate attorneys about minority stock transactions, a stock purchase agreement, and whether the appraiser should comply with the plaintiffs' document requests. The defendants claimed the information was confidential attorney-client communications under New York Civil Practice Law and Rules (CPLR) Section 4503(a).

The plaintiffs countered that the defendants — with the help of the appraiser — had misrepresented the value of their minority interests and wrongfully concealed information indicating a higher value from their investment bankers. The plaintiffs further argued that the information was discoverable pursuant to the crime-fraud exception to the attorney-client privilege.

The court's call

The scope of attorney-client privilege is decided on a case-by-case basis. Here, the New York Supreme Court ruled in favor of the plaintiffs, confirming that attorney-client privilege doesn't generally extend to communications between a valuation expert and attorney.

Furthermore, many communications on the defendants' privilege log were discoverable because they had been principally made on behalf of Mr. Zak, in his individual capacity, not as an agent of PSI.



Subject to discovery

On the one hand, expert witnesses want to know all details relevant to their opinions, and they expect to maintain thorough workpaper files to support their opinions. On the other, everything in an expert's paper and electronic files — including financial documents, draft reports, e-mails, minutes from settlement meetings, and reviewed workpapers — may be subject to discovery.

Thus, before sharing information with a financial professional or committing a conversation to writing, business owners and their attorneys need to consider how opposing counsel might use it in the case at hand — or in any future cases. Executives and attorneys should also encourage their experts to maintain clean, concise workpaper files. ♦