Fall 2012 Newsletter

Nordetek Environmental, Inc. v. RDP Technologies, Inc.
[U.S. District Court, Eastern Distr. of Pennsylvania, decided May 16, 2012]

Two brothers ran a waste water treatment technology firm, until one brother decided he wanted out, formed his own firm and began competing against his brother. The original firm's business was based upon a license to use the Tekkum patent. As soon as the departing brother left, he sued the original firm for patent and trade infringement; the latter countersued him for breach of fiduciary duty and under the terms of a non-compete agreement.

Eventually, the brother agreed to arbitrate a single issue: what was the value of the departing brother's stake in the original firm when he left. After review of competing appraisals, the arbitrator, a retired federal judge, determined that the value was 43% of $6.5 million. The arbitrator specifically declined to rule on any damages which may accrue to the company due to alleged misconduct. Accordingly, the parties returned to federal court, each filing a motion to dismiss the other's claims; the brother also filed a *Daubert* motion.

The company's expert rejected the "cost to cure" approach to measuring damages because the company never kept records of such costs. He also rejected the lost profits analysis because no projections of income or cash flows existed. The expert finally used a "diminution of value" analysis attempting to value the difference between the value of the company before and after the alleged harm. Such, however, could not be based on a market approach [no guideline companies available] nor an income approach for the same reason as the lost profits approach [no projection.] The expert accordingly adopted the $6.5 million value of the arbitrator as the "reasonable measure of the un-harmed FMV of the business.' Since the book value at the same time was $1.3 million, the expert indicated that the difference represented the unharmed value of intangible assets such as "licenses, customer relationships, backlog, experienced workforce, proprietary info and know-how, goodwill and the like." Without the Tekkum license, he reasoned that the intangible assets would be in part if not totally impaired. Further, without the "enabling" asset [the license] customers having already booked business may be tempted to cancel. Hence the value would tend to decrease to the level of the tangible net assets only.

The opposing expert managed to convince the court that this reasoning was in error because the diminution in value theory only applies to "entities facing a complete destruction or at least a slow death." The writer has checked the sources cited, and, in his opinion, they do not totally constitute acceptable valuation theory. In summary, this decision does not appear to solve a particularly egregious set of circumstances occasionally found in litigation between private companies. The judge however did indicate that, despite their loss on the expert evidence, the Company could still recover the costs of restoring its license, which he left to a trial court to determine. Since the Company has no data [see above] that Court will be busy.

In *Wimmer*, the issue was whether gifts of limited partnership interests made from 1996 to 2000 qualified for the federal Gift Tax annual exclusion under IRC 2503[b.] The focus thus was solely on the distinction between a present interest gift - which is subject to the annual exclusion - and a gift of a future interest, which is not. No discussion of valuation discounts was relevant in this case. The Court decided that recipients of gifts of limited interests in the partnership received a sufficiently substantial present economic benefits to render the gifts present interest, and thus subject to the annual exclusion. The determination was based on the fact that (a) the partnership generated a steady income [because it was invested in dividend-paying stocks,] (b) some agreed-upon proportion of partnership income was paid to the partners, and (c) that the donee's portion of the income was readily ascertainable. Typical partnership agreement provisions included restrictions on transfers requiring agreement of the general partners and of 70% of the limited partners.

Regulations define "future interests" as including reversions, remainders, and other interests and estates, whether vested or contingent and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date of time [Gift Tax Regs. 25-2503-3(a).] A "present interest" is an unrestricted right to immediate use, possession or enjoyment of property or the income from property [Gift Tax Regs. 25-2503(b).]

Earlier Tax Court decisions on the issue were less favorable to the tax payer, but were based on similar reasoning. In *Estate of Hackl* [118 T.C. No. 14, filed March 27, 2002,] the taxpayer had created an LLC holding a tree farm and proceeded to gift units to family members. The Service objected to the annual exclusion of the gifts because unusual restrictions in the operating agreement restricted the value of the gifts: the manager had the right to succeed himself, and could prevent capital distributions and transfers between members. Given the long-term nature of the business, the LLC, not surprisingly, did not distribute income during the first year. The Court took this as an indication that donees were unlikely to receive any immediate benefit to categorize the gifts as present interests. The Hackl court used a 3 prong test: involving the receipt of income, steady flow to the beneficiaries, and determination of that cash flow. The Wimmer case is, in fact, a logical continuation of Hackl and critics of that line of reasoning suggest that, in fact, only giving of partnership interests holding marketable, dividend-paying equity securities qualify as gifts of present interests. In the Hackl matter, the tree farm was likely to make money in the long run, but did not receive present interest status, perhaps an unfair result.

In *Price v. Commissioner* [T.C. Memo 2010-2] the Court found that the agreement so fundamentally restricted the donees' right as to render them contingent: no right of assignment without consent of all partners, no right to withdraw their capital accounts, no ascertainable portion of income flowing to the donees, based on the testimony.

In *Fisher v. U.S.* [105 AFTR 2nd 2010-1347 (Southern Distr. Court of Indiana)] the issue was again whether gift of partnership interests were present interests in property subject to the annual exclusion. The partnership owned a parcel of land bordering Lake Michigan. While all partners had the right to share in distributions, such were subject to the approval of the general partner and other contingencies. The fact that the partnership may never generate income before it would sell the land was also a factor, and the Court termed the donees' rights "non-pecuniary benefits."

As an appraiser, I have seen very small businesses being transferred under the annual exclusion, of course over a number of years. There are probably still many operating businesses which should qualify for the annual exclusion, but the Courts appear to be against it except for very predictably liquid investment vehicles.

S corporations: Is There Any Other Way ?

By now, the S corporation tax status has been available to most corporations for many years. Most new entities are now chartered as S corporations, unless they are to be listed, or are to have too many shareholders to comply with the rules. My work as a business appraiser reflects this: approximately 2/3 of my valuation clients are structured as S corporations, while some of the more durable ones still pay their own taxes [and complain during good times] and/or are considering an S election. If you are still operating a C corporation, perhaps you should review why and consult your tax adviser about the business's specific considerations. If you elect to switch to S status, a fair market appraisal will need to be done as of the date of the election.

The principal advantages of the S corporation status are:

* A Single Layer of taxation: shareholders escape the double taxation of earnings because they are taxed at the shareholder level at personal rates, i.e. the S corporation is a pass-through entity. While the income of the corporation continues to be taxable, shareholders do not incur any other tax to receive distributions [C corporation pay their own income tax, and dividends are then taxed at dividend rates when distributed to the shareholders.]

* Step-Up in basis: S corporation shareholders receive a step-up in their basis in the stock based upon the amounts of retained earnings. A step-up in basis reduces the amount of capital gain recognized by the shareholder when a sale of the business occurs.

Of course, these advantages generally enhance the after-tax proceeds for shareholders after a sale of the company takes place. An asset sale of a C corporation will lead to double taxation: first gains inside the corporation are taxed, then proceeds after distribution are taxed at the dividend rate. Accordingly, the tax structure of an S corporation allows for a more efficient way to receive proceeds from a corporate investment.

The principal disadvantages of an S corporation election are:

* Cash Flow versus Tax Liability: Regardless of whether a distribution is made, S corporation shareholders will owe their pro-rata share of corporate profits. This can be a problem for firms without sustained probability, the need to re-invest heavily in the business or start-ups.

* Built-in Gains: If any of the S corporation's assets are sold within 10 years of the S election, the gain is taxable to the company, not very different to C corporation treatment. For a growing company, converting sooner rather than later will at least minimize the amounts of the gains captured during the 10 year period.

* Shareholder limitations: S corporations can not have more than100 individual shareholders; however, since the 2004 tax act, family members who are S corporation shareholders can elect to be treated as one shareholder.

In the current environment, asset values are relatively low due to the timid recovery, tax rates are low but could be increased as soon as the end of 2012; in many cases, recent earnings are also lower, which could trigger lower appraised business values. All this would make an election from C corporation to pass-through entities particularly advisable.

Law Professor Tells It Like It Is on the subject of Tax Reform: not good for the vast majority of Americans, only "strings along" the wealthy; Ideal for Congress in Its Thirst for Campaign Contributions !

In a August 12, 2012 paper of the University of Southern California Law School, Law Professor E. J. McCaffery issued a serious challenge to Congress as well as to the rest of the voters. The logic is [alas] strong, and I certainly urge all to read this important article, which has now been re-published by several academic web sites, in particular at: http://www.stanfordlawreview.org/online/dirty-little-secret-estate-tax-reform. A copy has been placed at http://www.NYNJCT-BV.com/McCaffery.pdf. Can we expect Congress to do its job any time soon ?

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