

Tax Court Takes Own Approach to Value Undivided Interests in Real Estate

A decision issued on May 10, 2010 by Judge Halpern of the U.S. Tax Court implied a tougher stance on discounts for undivided interests in real property. The facts in *Ludwick v. Commissioner* were as follows:

A couple owned a vacation property as tenants in common. In 2005, they transferred their respective one-half interests into a qualified personal residence trust. At the time of transfer, the property had a fair market value of \$7.25 million with annual operating costs of \$350,000. Upon filing separate gift tax returns, the couple discounted their respective half-interests by 30 percent for lack of marketability and liquidity. The IRS permitted a discount of only 15 percent which was further reduced to 11 percent at trial.

Judge Halpern's view was that a buyer would discount the value of the undivided interest by only the cost of liquidating his/her investment.

The Court then devised its own value for the undivided half interests. In doing so, it considered two scenarios. Under the first scenario, the Court utilized a 10 percent rate of return (the rate used by the IRS' expert), assumed a two-year partition period and annual operating costs of \$175,000 plus other costs. The Court also considered a non-partitioning scenario. After weighting the values derived from the two scenarios, the Court concluded a total discount of approximately 17 percent for the 50 percent undivided interest in the property.

Tax Court Finds 'Good' FLPs Come from Good Families

Estate of Shurtz v. Commissioner, 2010 WL 374528 (U.S. Tax Ct.)(Feb. 3, 2010)

For nearly 30 years, Charlene Shurtz and her husband, an ordained minister, performed missionary work overseas. When they returned to the U.S. in 1996, they continued to do church work and donate substantial sums to charity from Mrs. Shurtz's independent wealth: She owned a 16% limited partnership interest in her family's timber company as well as 780 acres of prime Mississippi timberland.

To plan and preserve their estate, the Shurtzes formed a family limited partnership (FLP).

Because she owned the timber outright, Mrs. Shurtz transferred a 6.6% interest to her husband, who exchanged this for a 1% general partnership interest in the FLP. At the same time, Mrs. Shurtz donated all the remaining timber to the FLP plus her 16% interest in the operating company, for which she also received a 1% general partnership interest and 98% limited partnership interest in the FLP. From 1996 until 2002, Mrs. Shurtz gifted numerous interests to her children and grandchildren, reducing her LP interest to 87.6%.

The partnership maintained capital accounts and issued appropriate disclosures. It did not keep formal books, although the family's CPA created schedules to track balances and prepare taxes.

The FLP had a money market account, but relied on the Shurtzes to pay some disbursements from their personal accounts, ultimately reimbursing them or crediting their capital accounts.

Partner distributions were not always proportionate, but the FLP made up any discrepancies over time. The FLP held regular meetings in conjunction with the family timber business; its timber holdings required active management, including annual planting, reforestation, and maintenance.

When Mrs. Shurtz died in 2002, her 87.6% LP interest was valued at just over \$6.1 million and her GP interest at \$73,500. Because her estate plan disbursed nearly its total value—over \$8.7 million—to qualified marital and other trusts, it claimed no estate taxes were due. The IRS disagreed.

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Pursuant to IRC Sec. 2036(a), it taxed the full value of the FLP's underlying assets.

The taxpayer claimed the Sec. 2036(a)(1) exception applied (i.e., the FLP transfers constituted a bona fide sale for adequate consideration). To resolve the issue, the Tax Court looked to the following factors in support of the FLP's bona fide, non-tax business purpose:

- The Shurtzes had a legitimate concern to protect their family's assets from creditors.
- Mississippi is particularly known for its "jackpot justice," the court said, and FLPs are a "customary response" to guard against potential lawsuits.
- The FLP facilitated the management of the timberland, which comprised less than 16% of the FLP's total assets, but was sufficient to support the stated business purpose. By giving away 6.6% of her acres to her husband, Mrs. Shurtz also helped establish a bona fide transfer.
- The partnership conducted regular business with respect to the timberland, including an annual amortization of expenses and a realized gain from a 1997 harvest.
- The partners received interests in the FLP proportionate to their ownership contributions, and their accounts were properly adjusted for any contributions and distributions.

In conclusion, the court found that the FLP "was carried out in the way that ordinary parties to a business transaction would do business with each other." Thus, the transfers fell within the Sec. 2036 exception, and the fair market value of Mrs. Shurtz's FLP interest, rather than the fair market value of the contributed property, was includable in her gross estate, with no additional estate taxes due.

Creating 'But-for' World of Patent Damages Is Not the Same as 'Fantasy' World

Calloway Golf Co. v. Acushnet Co., 2010 WL 725728 (D. Del.)(March 3, 2010)

The parties are both manufacturers of golf balls—but only the plaintiff holds the patents to a multilayer, polyurethane design with a "dual" personality (i.e., a traditional hard-surface ball capable of traveling long distances while maintaining its playability and spin control).

The defendant admitted that its balls were infringing, but argued that the plaintiff's claims were invalid for anticipation and obviousness. (In essence, the design was so obvious that a person of ordinary skill in the relevant industry would have been able to anticipate or assemble it from the available art.) It moved for summary judgment and also moved to strike the plaintiff's financial expert under Rule 702 of the Federal Rules of Evidence and the *Daubert* standard.

Reasonable royalty and reasonable certainty. U.S. patent law (35 U.S.C. §284) permits a patent owner to recover a reasonable royalty for a competitor's infringing

sales. Lost profits are warranted for any additional sales that the patentee would have made, "but for" the defendant's infringement. A successful lost profits claim must show four factors, based on the landmark *Panduit* test: 1) demand for the patented product; 2) absence of acceptable noninfringing substitutes; 3) the patent owner's capacity to exploit demand; and 4) the resulting profits (*Panduit Corp. v. Stahl Bros. Fibre Works, Inc.*, 6th Cir. 1978). The proof need not be absolute; rather, the patentee must show the additional sales to a reasonable certainty.

This standard required the plaintiff's expert to recreate a particular model of the market, the defendant claimed. Specifically, the expert should have assessed what the defendant would have offered if the infringing ball were not available; how the market would have responded to these offerings; or what the market would have looked like had the defendant withdrawn the infringing design.

The defendant's proposal went beyond the *Panduit* factors and the standard of reasonably certain proof, the court held. It essentially asked a plaintiff's expert not only to create a "but for" world, but also a "fantasy world" of damages. "To credibly demonstrate that [the defendant] would have had viable, non-infringing alternatives to offer ... as well as how the market would have responded to these alternatives ... is an exercise that may be appropriate," the court said, "but certainly is not one that is mandatory in light of its speculative nature."

The plaintiff's expert accounted for noninfringing substitutes by allocating market share among the plaintiff and each of its competitors. He permissibly included infringing sales by the defendant as well as its subsidiaries. (Although the subsidiaries did not own the patents, their profits flowed directly to the parent company and were includable in the damages calculations). With respect to the premium golf ball market, the court found that his report was grounded on "real world facts" and his reasoning was reliable. "For any economic hypothesis to account for *all* variables is not possible, let alone required," the court emphasized, and it denied the defendant's *Daubert* motion.

The court did not provide any additional details regarding the expert's methodology or conclusions. It denied the defendant's motion for summary judgment on anticipation, however, leaving the weight and credibility of the expert's evidence for further examination and resolution at trial.

Critical Questions to Assess the Value of Patented Inventions

The value of a patented invention becomes important in current accounting practices, given the requirement for intangible assets to be recorded at their "highest and best use." Essentially, this requires valuing the probability that the invention's owner will obtain a licensing agreement with a company capable of delivering the patented invention to market. To assess the probability of securing a license, accounting executives, auditors, and their attorneys should discuss the following factors with their valuation experts:

Market potential. Does demand for the patented invention already exist? Technologies that facilitate natural extensions of products into new markets offer high risk-adjusted value (e.g., placing social media applications on “smart” phones).

Strategic motivation. How badly does the customer need the technology? Firms with enormous revenues at risk, high rates of obsolescence, and few remaining years of patent life (e.g., pharmaceutical companies) are usually motivated to adopt new technology. By comparison, firms that face less competition and deliver basic technology are likely to wait until the technology expires.

Investment costs. What is the cost to deliver the technology to the market? How long will it take to deliver? Will market demand continue in the meantime?

Development risks. Is the technology in early stages of development or is it already incorporated into a product? Does the license include all of the relevant technology? How might the license infringe on existing, lawful patents?

Implementation risks. Has the technology been independently validated (e.g., by a “freedom of operation” opinion letter, business model, or customer contract)?

Genesis of the invention. Who brought the invention to the licensee’s attention? Offers from licensing agents, patent brokers, or lawyers have often been vetted and are well-received by licensees. Inventions that solve “real” problems are also better received than those developed by happenstance.

Licensee’s commitment. Has the licensee developed licensed technology in the targeted markets? Does the technology serve the licensee’s primary or ancillary business units? Are there sufficient research dollars, personnel, capital, and capacity to deliver the product—or do the licensee’s lawyers, R&D, or other staff oppose the initiative?

Inventor’s reasonableness. Does the inventor have unrealistic expectations regarding the invention’s value? Is the inventor willing and able to participate in negotiations? Is the inventor committed to improving and/or commercializing the technology?

Negotiations. Do the negotiators have appropriate decision-making authority? Is there an internal champion for the project? Are negotiations progressing smoothly? Is the licensee willing to sign off on nondisclosure agreements, term sheets, etc.?

“fair value” standard. The parties had been involved in the early-stage development of untested medical technology.

The parties agreed upon a valuation expert whose report “set forth clearly and in layman’s terms the factors, limitations, assumptions, and methodologies used to determine fair value.” In particular, the IP expert applied the income approach to determine the company’s fair value, using a discounted cash flow method and statistical modeling “to account for unforeseen events and circumstances that influence value,” he said. Among other factors, his models considered:

- Workforce, working capital, and operating budgets
- Capital requirements and revenue recognition policies
- Product warranty returns and allowances
- Prior licensing agreements with similar technology
- Discount rates and currency/country risks
- Taxes and regulatory environment
- Market acceptance and target market trends

The expert’s models also incorporated factors specific to IP valuations, including sustainable competitive advantage, risks related to the technology, functional realization, patent protections, infringement detection, and the potential for design-around technology.

The majority shareholders criticized the expert for using “hypothetical information and extraordinary assumptions,” and for overstating the technology’s value. The minority shareholders also found flaws with his report, accusing the expert of underestimating value, particularly in his rejection of the market approach and his selection of a discount rate.

The court-appointed expert addressed each criticism at trial, satisfying any concerns of the court.

“Any shortcomings ... can be attributed to the intrinsic uncertainty of early-stage IP valuations,” it said, and accepted the expert’s range as an objective, reliable indicator of fair value. By the time of trial, however, the company had landed two new licensing agreements with royalty numbers below the expert’s estimates. Further, a “key player” in the development of the technology had unexpectedly died, forcing the company to delay its marketing plans and reduce its portfolio.

Given the additional uncertainties posed by these subsequent events, the court declined to bind the parties to a fixed buyout amount. Instead, the court exercised its statutory option to create a royalty-sharing arrangement, selecting a rate on the lower end of the expert’s range. Should the parties appeal its decision, the court provided an alternative designation of fair value, also deriving the number from the lower end of the expert’s range.

Expert Helps Court Tackle the Complexity of IP Valuations

Vernon v. Cuomo, 06 CVS 8416 (N.C. Super. Ct.)(March 15, 2010)

In this dissenting shareholder case, the court found the majority shareholders liable and permitted them to buy back the minority shareholders’ interests at the statutory

VMI Highlights

- **Valuation of gas royalty rights relating to the Marcellus Shale** - VMI prepares appraisals of the subsurface and mineral estate (gas royalty rights) connected to properties (both producing and non-producing) in the Marcellus Shale region. VMI works with an experienced certified petroleum geologist (nearly 20 years) with an excellent reputation in the Appalachian Basin. Combining this expertise with our valuation knowledge results in a comprehensive gas royalty rights appraisal that can be used for financial planning, and gift & estate tax purposes. Please contact VMI with any Marcellus Shale related valuation questions.
- VMI is sponsoring the Philadelphia Estate Planning Council luncheon on October 19 at the Union League. The speaker will be **Abby Joseph Cohen** of Goldman Sachs. Her topic is, "Investment Outlook." Please contact Susan Wilusz if you would like to attend this luncheon as VMI's guest.
- VMI will be a conference sponsor at the 15th Annual Multi-State ESOP Conference on September 15 and 16 at the Hilton Scranton & Conference Center. For more information on this conference, please contact VMI.
- Congratulations to **Value Management Inc.**'s Andrew Wilusz, Director of Mergers & Acquisitions, who was recently elected President of the Philadelphia Estate Planning Council. Andrew's one-year term will begin September 1, 2010. The Philadelphia Estate Planning Council is an interdisciplinary organization for professionals involved in estate planning, providing its members with opportunities to enhance their skills and expand their network through programs and interaction. It is the largest estate planning council in the country.
- Congratulations again to Andrew on being elected President of the Philadelphia Chapter of the American Society of Appraisers (ASA). The ASA is an international organization of appraisal professionals and others interested in the appraisal profession. ASA is the oldest and only major appraisal organization representing and accrediting all of the disciplines of appraisal specialists.
- Susan Wilusz, Marketing Coordinator, was recently elected to the Bucks County Estate Planning Council's Board of Directors.

If you are interested in having one of our analysts give a business valuation related presentation to your firm or at a conference, please contact Susan Wilusz at smw@valuemanagementinc.com or at 215.343.0500.

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