

J.M. Huber Corp. A Study in the Gifting of Closely Held Stock

Michael W. and Caroline P. Huber, et al., Petitioners v. Commissioner of Internal Revenue, Respondent
United States Tax Court, T.C. Memo 2006-96, May 9, 2006

When it came to gifting stock in the family business, J.M. Huber Corp. (“Huber”) got it right. Business advisors often bemoan their closely held clients’ lack of procedure, but such was not the case with Huber. Beginning in 1993 to the present, Huber has retained Ernst & Young (“E&Y”) to prepare an annual valuation of the company which is then reviewed year by the chair of Huber’s audit committee. When the IRS challenged gift tax valuations involving Huber stock for the years 1997 through 2000 based on E&Y conclusions, the reported values were upheld. Although Huber is not a small company, nonetheless, much can be gleaned for the closely held advisor, if only to have his or her clients aware of a viable way to report defensible stock values for sales and gift transfers of its own stock.

The Huber matter specifically concerns the proper amount of gift tax that Michael W. and Caroline P. Huber, Tabitha A. Huber, and Hans A. and Laurel D. Huber should pay on gifts of J.M. Huber stock. The reported gift values were based on the prices Huber used for shareholder stock transactions. The IRS contends that the shareholder stock transactions, and hence the gift values, do not constitute arm’s length transactions.

Huber, located in Edison, New Jersey, is a printing business which generates annual sales of \$500 million. The Company, originally located in New York City, was found by Joseph Maria (J.M.) Huber, a German immigrant, in 1883. During the relevant taxable years there were approximately 250 shareholders, who were generally Huber family members, as permitted by Huber’s bylaws. Although privately held, Huber strives to maintain a high level of communication with shareholders. The Company is governed by its board of directors (“the board”), the majority of whom are not members of the Huber family. There are also 3,000 to 5,000 employees, most of whom are not related to the Huber family.

Huber bylaws permit sale of Huber shares to Huber family members and the Huber Foundation. In addition, the bylaws also authorize shareholders to sell to independent nonprofit organizations after obtaining a waiver from the board. Huber’s bylaws provide the corporation the right of first refusal to purchase shares offered outside the Huber family at a price specified in the bylaws.

During the period from 1994 to 2000, there were approximately 90 transactions of Huber stock. The shareholders are not obligated to use the E&Y value to sell their shares and the relationship between buyers and sellers varied. In some instances the stock sales were within the immediate family and in others they were as distant as between a trust and the spouse of a second cousin.

In finding in favor of Huber and its shareholder petitioners, the Tax Court looked favorably upon a number of practices of Huber, its Board and its shareholders. A few are discussed below. Visit our Website, koenigassociatesllc.com, for the full discussion.

Annual Independent Valuation

Since 1993, E&Y has prepared an annual independent valuation of Huber. E&Y does not perform any auditing function for Huber. Furthermore, E&Y has used a consistent methodology for valuing Huber shares, including a 50-percent lack of marketability discount.

Arm’s Length Transaction

The IRS contends that the Tax Court consistently scrutinizes purported transactions between related parties, such as family members. In the instant case, there were over 90 transactions that took place between 1994 and 2000 by Huber shareholders. The relationships varied from immediate family to more distant relatives and between shareholders of Huber and independent nonprofit organizations. The Court concluded that many sales took place between parties who had no reason to accept a price that was artificially low. The existence of a close family relationship in some of the transactions is neutralized by the many transactions that took place between parties that were hardly related or who had a fiduciary responsibility to obtain the best price.

Communication with Shareholders

Shareholders are not generally sent copies of the E&Y annual valuation report, but the reports are available for inspection by Huber shareholders. The petitioner, at trial, showed that those shareholders entering transactions in Huber stock had seen the report or at least discussed the value of Huber with a financial officer or at a shareholder meeting. The Court opined that whether the shareholders actually saw the report does not influence its conclusion that the petitioners were well informed because the modus operandi of Huber gave plenty of opportunity for shareholders to educate themselves about the Company and E&Y methodology.

A review of Huber might have the advisor to closely held companies thinking these criteria are clear academic strategies. After all, wouldn’t we all advise our clients to have regular periodic valuations, if not annual? This is particularly so if we perceive value and have more than a handful of shareholders. We would certainly advise shareholder meetings and adherence to bylaws in place. Huber refreshes those who would advise the closely held client to get their house in order. While we can’t guarantee an outcome, it’s reassuring that a favorable outcome came to a closely held company that did things by the book.

Case Update - Personal Goodwill versus Entity Goodwill

The Saga Continues

Many states outside New Jersey are beginning to segregate personal goodwill from entity goodwill and to declare the personal goodwill segment a non-distributable asset of the marital estate. New Jersey, however, appears to be bucking the trend. The spirit of *Brown v. Brown*¹ tells us that there should be no academic reductions in the value of a titled spouse's interest if there is no intended sale of the business. In *Piscopo v. Piscopo*², the family court would not deprive a spouse from sharing in "celebrity goodwill."

In February/March of 2004 we last visited the issue of Personal Goodwill versus Entity Goodwill. A review of recent cases from other states continues to show a trend toward the separation of Personal v. Entity Goodwill. This trend appears to favor the exclusion from the marital estate of Personal Goodwill in professional practice circumstances while including all goodwill associated with an operating entity in the marital estate. Despite the pattern which is being established, contrary rulings exist. An update on five recent cases follows.

1) Personal Goodwill Considered

In *In re the Marriage of Brumback*³, the Washington Court of Appeals considered whether an attorney had personal goodwill. Two years prior to divorce, the husband, an attorney, formed a personal injury law firm in which he received a 25 percent interest. A second attorney received a 25% interest and a third original partner, the "rainmaker," received a 50% interest. Based on a recent divorce of the other 25% partner which valued his 25% interest at \$135,000, the husband's expert in the current matter valued the husband's interest at \$135,000. The trial court agreed and placed a \$135,000 value on the husband's 25% interest in the law practice. The wife appealed, claiming the practice had a value of \$204,000, including personal goodwill ranging from \$50,000 - \$163,000.

The appellate court affirmed the trial court's valuation of the husband's 25% interest at \$135,000 without personal goodwill. In reviewing the case, the court looked to the *Fleege*⁴ factors: age, health, past earnings power, reputation in the community and comparative personal success to ascertain whether the husband had any personal goodwill. It concluded that the rainmaker was the partner that possessed personal goodwill, inclusive of his long-term relationships and reputation. It appears the Court would have excluded personal goodwill had it found such goodwill to exist

2) Personal Goodwill Excluded from Marital Estate

In *In re Marriage of Schneider*⁵, the Illinois Supreme Court considered questions involving personal goodwill. In 1987, during the marriage, the husband acquired a dental practice. The husband filed for divorce in September 2000. The trial court did not include any value for goodwill because, in their view, personal goodwill should not be included in the value of a professional practice. The wife appealed and the appellate court found that inasmuch as she had waived maintenance, personal goodwill could be included in the valuation of a professional practice. The husband appealed to the Illinois Supreme Court, which agreed with the husband that the appellate court erred when it included personal goodwill in the valuation of his dental practice. The Supreme Court states "...The goodwill in a professional practice is generally personal in nature, while the goodwill in a corporation might include both personal and enterprise goodwill."

In *Lisa Womack Gill v. Craig Gerard Gill*⁶, the Louisiana Court of Appeals considered the trial court's valuation of a husband's funeral home and a wife's accounting business. After the trial court's consideration and the parties' appeal, the Court of Appeals upheld the trial court's finding that the increase in the value of the accounting practice during the marriage was not subject to equitable distribution "because the business was a professional practice and relied solely on the wife to generate its income." Furthermore, the Court of Appeals recognized that it was appropriate to include goodwill in the valuation of the husband's funeral home. This case brings together the exclusion of personal goodwill in a professional practice and inclusion of entity goodwill in an operating entity.

3) Personal Goodwill Included in the Marital Estate

In *Andrew Simon Mickler v. Terry J. Mickler, et al.*⁷, the Kentucky Court of Appeals considered the lower court's valuation of the husband's medical practice, including goodwill. The wife's expert concluded that the business had a fair market value of \$218,123, including \$170,925 in goodwill. The husband's expert determined that the practice had a fair market value of \$18,704, exclusive of goodwill. He did not factor in goodwill because "the only goodwill associated with a private practice is personal goodwill which is not a marketable business asset since it cannot be transferred unless that person stays with the business." The trial court accepted the valuation put forth by the wife's expert which included personal goodwill. The husband appealed. The Kentucky appellate court upheld the lower court, stating "His goodwill has value despite its immarketability, and so long as he maintains his...practice...he will continue to receive a return on the goodwill associated with his name."

On December 15, 2005 in *Kim Brown v. Carlton Brown*⁸, The Tennessee Court of Appeals affirmed the lower court's decision denying a deduction for personal goodwill in the valuation of the parties' business. Since neither party's valuation expert valued the personal goodwill separately from the enterprise goodwill, notwithstanding that each expert opined at trial as to the presence, or lack of the presence of personal goodwill; the lower court did not err in not allowing a deduction.

Although a trend is emerging, the saga continues. In situations where this issue exists, the courts are looking for well reasoned arguments for the inclusion or exclusion of personal goodwill regarding the marital estate. Knowledge of the *Fleege* factors referred to above appears essential if one wishes to argue for the exclusion of personal goodwill from the marital estate.

¹ (348 N.J. Super. 466, 7922 A.2d 463)

² 231 N.J. Super. At 576

³ Unpublished, No. 21857-1-III (Wash. App. July 8, 2004)

⁴ In re Marriage of Fleege, 588 P.2d 1136 (Wash.1979) looks to five listed factors in assessing whether there may be personal versus entity goodwill. See Koenig & Associates, L.L.C.'s website, www.koenigassociatesllc.com, for further discussion of the Fleege factors.

⁵ No. 97430 (Ill. January 21, 2005)

⁶ No. 39,406-CA (La. App. 2 Cir. March 9, 2005)

⁷ Unpublished, No. 2003-CA-000822-MR (KY App. April 2, 2004)

⁸ No. M2004-01573-COA-R3-CV (Tenn. App. 2005)

The opinions in this newsletter are for general information only, and not intended to provide specific advice or recommendations for any individual or business. This information is in summarized form and has been obtained from sources believed to be reliable.

If you have any comments or questions on materials contained in this newsletter, contact our office or log onto our website.