



Advocate's Edge

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PLUS! Court finds equitable cash remedy taxable



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Valuing patents: An intellectual exercise

Back in the mid-1800s, the *Economist* magazine likened patents to lotteries, “in which there are a few prizes and a great many blanks.” Indeed, it’s estimated that less than 80% of issued patents are actually used and that many patents are worth less than their registration and maintenance fees.

Still, the value of a single patent can play a pivotal role in many types of cases. Patent valuations may be needed in connection with business sales or combinations, shareholder litigation, bankruptcy, estate and gift tax matters, divorce, and, of course, patent sales or disputes. The process is often complicated, calling for consideration of many factors specific to intellectual property. (See “Choosing an appropriate valuation method in patent situations” on page 3.)

Preliminary steps

It may seem obvious, but the first step is to determine whether the patent remains in force; in other words, are the maintenance fees up to date? The fees must be paid to the Patent and Trademark Office (PTO) 3.5 years, 7.5 years and 11.5 years after the patent is issued. Some delays are curable, but a patent holder that misses the cutoff could lose the patent for “abandonment.”

A patent is less valuable if its validity is subject to challenge.

Once that’s established, the valuator needs to review a variety of documents, including:

- ✓ The patent application file, with all PTO correspondence,
- ✓ A list of any foreign patent applications,
- ✓ Any related contracts, licensing agreements, or outstanding offers,



- ✓ Cost information,
- ✓ Previous valuations,
- ✓ Files from any litigation, completed or pending,
- ✓ Business plans,
- ✓ Marketing studies,
- ✓ Financial statements,
- ✓ Marketing materials used to promote the patent or its related product, and
- ✓ Economic data for the applicable industry.

Critical valuation factors

The valuator analyzes several important factors, including:

Scope. The patent’s scope is perhaps the most important factor because a patent’s value is so closely tied to the legal rights it confers. The valuator must determine just how far those rights extend.

Remaining life. The valuator considers not only the remaining term on the patent but also its remaining economic life. A patent’s economic life may be cut short if technological or other developments render the invention obsolete.

Validity. A patent is less valuable if its validity is subject to challenge. Did the patent holder satisfy the statutory requirements for obtaining a patent?

Other legal factors. These include ownership of any foreign patents, which expand the market and,

therefore, the patent's value. The outcome of prior litigation is also important. If the patent holder prevailed, the patent's validity is strengthened; an unsuccessful attempt to enforce a patent, on the other hand, diminishes its value.

Royalties. The valuator examines past royalties paid and determines whether changed circumstances increase or decrease the amount of future royalties.

Alternative technologies. Alternative inventions can provide information on cost savings (from using the patent) or price premiums (from the sale of

products) associated with the patent. The valuator can then extrapolate the patent holder's potential market share.

Build a better valuation

Just as patent litigation requires attorneys with specialized knowledge, patent valuation calls for proven experience. A trained valuator with patent experience and an understanding of the intricacies of patent law offers attorneys the best chance of reaching a comprehensive and accurate valuation. ✨

CHOOSING AN APPROPRIATE VALUATION METHOD IN PATENT SITUATIONS

Valuators typically attempt to combine the market, cost and income approaches when appraising an interest in a business. But the market and cost methods can come up short when dealing with patents, making the income method most prevalent.



Market approach. Under the market approach, a valuator analyzes comparable assets or transactions and develops multipliers based on differences and similarities between the comparable items and the subject asset.

This can prove difficult to execute in patent situations, however, because of the lack of comparable patents. By its very nature, a patent represents a one-of-a-kind item; thus, the price of one patent will have little relevance to the value of another.

Even if a sufficiently similar patent can be located, patents are rarely sold at arm's length, making transactional comparisons virtually useless. Further, a valuator will likely find it hard to gain access to the insider information needed to evaluate a patent transaction objectively.

Cost approach. The cost approach generally looks at the cost to replace a subject asset. In the case of a patent, an appraiser might calculate the cost to replace the patented invention, incorporating development costs, but such a retrospective view can undercut a patent's value. The cost approach assumes the subject asset declines in value as time goes on, but patents often gain value over time.

Income approach. The income approach — which assesses value based on future economic benefits expected to be derived from the subject asset — probably provides the most suitable method for valuing patents. The method takes into account the net cash flow, the expected life of the income stream, and a discount rate. It may be royalty-based (using the income stream from licensing the patent) or profit-based (the income stream from sales attributable to the patent).

Using an old law to uncover new tricks

A long-recognized digital analysis technique has gained new prominence in recent years as an effective tool for detecting financial fraud. Forensic accountants can use Benford's Law to ferret out fraud where perpetrators have fabricated or altered numbers.

Understanding Benford's Law

The rule's name recognizes Dr. Frank Benford, a General Electric physicist, who discovered that in sets of random data, numbers beginning with 1, 2, or 3 are more likely to occur than those starting with 4 through 9. Studies show that numbers beginning with 1 occur about 30% of the time and numbers beginning with 2 occur about 18% of the time. Those beginning with 9 occur less than 5% of the time.

These probabilities have proven to be both "scale invariant" and "base invariant," meaning the numbers involved could be based on, for example, the prices of stocks in any currency. As long as a set includes at least four numbers, it's more likely that the first digit of a number will be 1 than any other single-digit number.

Catching fraudsters in the act

Benford's Law is making dramatic inroads in fraud detection. When fraud perpetrators fabricate data, their understanding of random numbers rarely matches reality. To avoid drawing attention, they choose figures they believe will appear random. They select a relatively equal distribution of numbers beginning with 1 through 9, in the mistaken belief that all nine digits are equally probable.

Studies show that Benford's law applies to a variety of financial data sets, including income tax data, stock exchange data, sales figures, demographics, and

scientific data. Accountants can apply Benford's Law to test figures in a wide range of financial documents, including:

- ✓ Tax returns,
- ✓ Inventory records,
- ✓ Expense reports,
- ✓ Disbursement authorizations,
- ✓ Accounts payable or receivable,
- ✓ General ledgers, and
- ✓ Refunds or returns reports.

The principle is simple enough to apply using a spreadsheet program.

Performing digital analysis

Although scientists have developed complicated software programs that employ Benford's Law to analyze massive amounts of data, the principle is simple enough to apply using a spreadsheet program.

Anyone armed with Excel, for example, can analyze random groups of numbers by examining the distribution of their first digits. Build a table with rows for each digit (1-9) and columns for 1) the frequency with which numbers beginning with each digit occur in the random sample, 2) the percentage rate that frequency represents, and 3) the expected frequency rate according to Benford's Law.

Excel can easily convert the spreadsheet into a chart that graphically depicts any significant discrepancies between actual and expected occurrences of first digits. A chart showing a peak in numbers beginning with 9 and only a few beginning with 1 should raise red flags.



Recognizing the exceptions

Benford's Law isn't infallible. It may not apply, for example, to smaller sets of numbers where the rules of randomness don't apply. Benford's probabilities also may not work out for sets of numbers with pre-established ceilings and floors. For example, if an employer requires receipts for meals that cost \$25 or more, an analysis of expense reports will reveal many claims just under the limit, in amounts like \$24.90.

Similarly, the law might not work where numbers have been rounded up or down, resulting in different first digits, or with prices, where 95 and 99 pop

up regularly as a result of marketing strategies. And bear in mind that Benford's law doesn't apply to assigned numbers, such as invoice numbers or Social Security numbers, or to uniform distributions, such as a lottery in which each number painted on a ball has an equal likelihood of selection.

Raising red flags

Mere deviation from Benford's distribution doesn't constitute solid proof of fraudulent behavior; deviations can arise for a variety of nonfraudulent reasons. They do, however, raise red flags that warrant further investigation. ✧

Attorneys' fees and income taxes: Is the issue finally resolved?

For years, the federal appellate courts split over the appropriate tax treatment of attorneys' fees in employment discrimination cases. The debate centered on whether contingent fees paid out of a judgment or settlement were taxable to the plaintiff.

Earlier this year, the Supreme Court settled the issue, ruling that plaintiffs must include these fees in their taxable gross income (*Commissioner v. Banks*, No. 03-892).

The decision came on the heels of the American Jobs Creation Act (AJCA), which created a new tax code provision that resolves the issue differently for most discrimination claims. AJCA wasn't considered in *Banks*, however, because the tax code change isn't retroactive. It only applies to fees and costs paid after the date of enactment, Oct. 22, 2004, with respect to any judgment or settlement occurring after the enactment date.

Settling the conflict

In *Banks*, the Supreme Court held that the anticipatory assignment of income doctrine, which prevents one from avoiding tax on an economic gain by assigning it in advance to another party, applies to contingent-fee arrangements. Thus, the attorneys' fee portion of a judgment or settlement constitutes

taxable income to the taxpayer, whether paid to the claimant or directly to the attorney.

The Court declined to address whether the anticipatory assignment principle conflicts with the purpose of fee-shifting provisions in some civil rights statutes, none of which were implicated in *Banks*. But it noted that AJCA redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.

Pre-AJCA dilemma: The deduction reduction

Before AJCA, plaintiffs who were required to include contingent attorneys' fees in their income were entitled to deduct those fees on their income tax returns, but the deduction was of limited value.

Attorneys' fees are generally categorized as miscellaneous itemized deductions, which are deductible only to the extent they exceed 2% of a taxpayer's adjusted gross income (AGI). In addition, itemized deductions are reduced when a taxpayer's AGI, including the taxable share of a judgment or settlement, exceeds a specified threshold.

In 2005, for example, itemized deductions are reduced by 3% of the amount by which AGI exceeds \$145,950 (\$72,975 for married persons filing separate returns),



up to a maximum reduction of 80%.

If these limitations weren't bad enough, the large sums often involved in employment discrimination lawsuits could wipe out the deduction altogether

because miscellaneous itemized deductions are disregarded in determining alternative minimum tax (AMT) liability.

Once considered largely irrelevant for most taxpayers, AMT now affects substantial numbers of middle-income taxpayers. Absent a change of law, it will affect more than 30 million taxpayers by 2010.

AJCA to the rescue

AJCA eases the tax burden on most discrimination plaintiffs by providing an "above-the-line" deduction for court costs and attorneys' fees paid in connection with most unlawful discrimination claims. The deduction is applied directly against gross income, so plaintiffs avoid the limitations on miscellaneous itemized deductions.

Bear in mind, though, that the deduction is limited to amounts includible in a plaintiff's gross income resulting from a judgment or settlement — in other words, the plaintiff can't claim the deduction before actually receiving the award.

Lower settlement costs

AJCA should lower the cost of settling discrimination cases by providing certainty about the after-tax value of settlements. The Supreme Court's decision in *Banks*, however, may have a negative tax impact on plaintiffs whose awards predate AJCA. ✧

COURT FINDS EQUITABLE CASH REMEDY TAXABLE

In the ongoing series of cases testing the Internal Revenue Code's (IRC's) definition of personal physical injuries or physical sickness, the Tax Court ruled last year that an equitable remedy settlement wasn't excluded from gross taxable income (*Kidd v. Commissioner*, T.C. Memo 2004-135).

THE FACTS

William Kidd brought a reverse discrimination case against the state of California. He claimed its affirmative action policy violated his rights under the U.S. and California constitutions. Kidd sought no monetary damages, only equitable relief.

While the suit was pending, the state personnel board concluded the program was, indeed, improper. The trial court dismissed Kidd's suit, but an appellate court remanded the case with instructions to "fashion an equitable remedy" to redress the violation of Kidd's rights. (He alleged no economic loss.) He eventually received a \$132,000 settlement, which he did not report on his income tax return. The IRS found Kidd liable for \$43,012 in income taxes.

THE DECISION

Because the settlement agreement failed to specify the reason for the payment, the court turned to IRC Section 104(a)(2)'s two-pronged test for excludability: The underlying cause of action must be based on tort or tort-type rights *and* the payment must be on account of personal physical injuries or sickness.

Kidd argued the suit was tort-like and the payment compensated him for a personal *physical* injury "of a latent type such as an injury to ... dignity or self-respect." The court disagreed, finding his injuries "most akin to emotional distress" and not attributable to physical injury or sickness.

WATCH YOUR WORDS

Although Kidd's argument may well have gotten hung up on the "tort or tort-like" prong anyway, this case again demonstrates the importance of careful settlement drafting. The agreement's language can have a significant impact on a plaintiff's net recovery. ✧

Getting back to normal

Adjusting business earnings to reflect true value

Financial statements aren't always a reliable indicator of business performance. An owner's high-flying lifestyle can contradict the story told by the statements. So how do you reach a true and useful value?

The first step is to determine the business's normalized earnings. These earnings give a more accurate picture of a company's financial position and allow for easier comparison with other companies.

Where to look

Business valuers typically adjust financial statements after examining several areas:

Accounting method. To reduce taxes or for other reasons, businesses sometimes use accounting methods that don't reflect their true performance. The cash method only records revenue as it's received and expenses as they're paid. The income tax method allows a business to defer certain revenues and to accelerate depreciation and certain other expenses. So business valuers often convert earnings calculations to an accrual basis, recording income and expenses in the periods they're generated.

Depreciation/amortization. Fixed and intangible assets are depreciated based on their estimated useful lives and the method of allocating costs over those lives. The lives and methods selected may bear little resemblance to the assets' actual economic lives and may not accurately reflect their current value. When companies routinely depreciate equipment over five years but use the equipment for twice that time, a valuator may adjust the financial statements accordingly.

Adjustments may also be needed when companies elect Section 179 treatment for equipment purchases. That provision currently allows a business to immediately expense up to \$105,000 of tangible property placed in service during the year.

Compensation and benefits. To develop an accurate picture of earnings, valuers should adjust excessive salaries, wages and bonuses received by business owners to reflect the value of the actual services rendered. Benefits, including retirement plans, club memberships, auto expenses, insurance, and travel and entertainment, should also be closely scrutinized for reasonableness and necessity. Comparisons with similar businesses can provide useful benchmarks.

Related party transactions. Business transactions with related parties — such as rental of an office or other business facility — may not be conducted at “arm's length.” To ensure financial statements are based on fair market value, they should be adjusted if the business pays above- or below-market rental rates or prices for goods or services from related parties. Sweetheart deals for favored customers also call for adjustments.

Inventory. The first-in, first-out (FIFO) inventory accounting method may yield more accurate information than the last-in, first-out (LIFO) method. The latter can understate inventory and depress earnings.

Repairs and maintenance. Repair and maintenance costs raise issues regarding capitalization vs. expensing. They may distort asset values and result in understated earnings.

One-time entries. Income or expense items that are unlikely to recur can also distort earnings. These entries might be traced to developments that come up in the ordinary course of business, including litigation, government contracts, or acts of God.

Achieving extraordinary results

Trained financial professionals who know where to look can best conduct the in-depth analysis needed to reach true earnings normalization. Their extensive experience with financial statements allows them to produce accurate and reliable documentation of a business's earnings. ✦



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