



Trugman Valuation ASSOCIATES, INC.

The certified leader in business valuation expertise™

TAX COURT CASE UPDATE

FCG Valuation Case E-Flash

Authored by John Walker and Chris D. Treharne, ASA, MCBA, BVAL of Gibraltar Business Appraisals, Inc., a member firm of FCG

Citation:

Estate of Robert C. Fortunato v. Commissioner, T.C. Memo 2010-105, May 12, 2010.

Overview:

In a trial lasting almost three weeks and involving more than 3,500 pages of testimony and more than 400 exhibits, the Tax Court determined that a manager for a national group of warehouse companies, although well-compensated, a key member of management, and brother of the sole owner, did not own an interest in any or all of the companies. As a result, his estate was correct in not reporting ownership of the companies on his estate tax return and the estate did not owe the additional tax or penalty asserted by the IRS.

The Facts:

Robert C. Fortunato was born in 1942. In his early 20s, he committed a series of crimes and was arrested several times, eventually serving six years in Sing Sing prison from 1963 to 1969. Upon his release from prison, the decedent began working for a warehouse and export business and within a decade became its co-owner and president.

However, severe financial distress caused by employees misallocating company funds and the company borrowing at high interest rates caused it to collapse in 1984. At the time of the company's collapse, the decedent owed more than \$490,000 to the IRS for employee withholding taxes and hundreds of thousands of dollars to foreign creditors, including some believed to be associated with the Chinese mafia.

As a result of the severe financial straits in which he found himself, the decedent hid from his creditors. He refused to sign, or even put his name on, any documents and did not maintain a bank account. At the same time the decedent was hiding from his creditors, his younger brother Anthony was setting up container freight station and warehouse businesses in New Jersey ("St. George NJ"). At the time of the companies' incorporation, the decedent was not asked to be, nor did he become, an investor in the new ventures.

However, the decedent eventually joined St. George NJ, acting as his brother's business strategist and shortly thereafter assuming leadership. The decedent's brother acted as the financial and organizational manager, while the decedent essentially ran the day-to-day operations and plotted strategy for the company. The decedent had no title, however, and did

1776 N Pine Island Rd, Suite 314, Plantation, FL 33322 T 954-424-4343 F 954-424-1416
2001 Rte 46, Suite 310, Parsippany, NJ 07054 T 973-983-9790 F 973-983-6686

www.trugmanvaluation.com

not appear on the company's payroll. The decedent's compensation was in cash, which he acquired through an employee writing a check to a fictitious person, cashing the check, and leaving the cash in a safe. As a result of the scheme, the decedent both avoided filing income tax returns and circumvented the Customs Service requirement for fingerprinting employees and officers of the company.

Between 1989 and 2001, St. George NJ struggled financially and the decedent's brother was forced to bail it out several times. At no point did the decedent contribute capital to the company, even as he expanded the company's operations from New Jersey to California. The decedent was not an incorporator of the California company ("St. George CA"), did not borrow money on St. George CA's behalf, and was not listed on the warehouse's bond license. After St. George CA struggled initially, the decedent moved to California to turn that company's operations around. He was successful in his turn-around efforts and enjoyed California enough to make it his permanent residence. As with his time in New Jersey, the decedent did not maintain a bank account, was not an officer of the California company, and refused to sign any documents. In spite of this, the decedent's brother (St. George CA's president) gave the decedent carte blanche in running the California operations. As a result of the decedent's brother's passivity, the decedent eventually began to refer to himself as the CEO or owner of St. George CA, even though no corporate documents listed him as such.

During federal tax amnesty in the 1990s, the decedent began filing his tax returns. However, his reported compensation was much lower than what he received. Most of his income was recorded on the California company's books as "officer salary," "professional fees" or "notes payable stockholder" even though the decedent was neither an officer nor a stockholder. St. George CA also paid for the decedent's housing, his car, and his entertainment. Although aware of the decedent's use of company funds for personal expenses, the decedent's brother was content to allow the decedent to run the California operations his way as long as the company continued to be successful. As the companies experienced continued success, the decedent's brother set up several other company locations in major hub cities, including Atlanta. All of the general managers in the hub cities reported to the decedent through the St. George CA operation.

In 2000, the decedent's brother considered selling the New Jersey portion of the company. A potential buyer emerged, but the buyer wished to purchase all of the warehouse companies. Marketing materials for the businesses indicated that the decedent was a partner in the businesses. The marketer, however, "did not mean...that he [the decedent] was an equity partner, just they're a partner in a business." Although initially reluctant, the decedent agreed to hear the buyer's offer for the companies. Part of the offer was a demand that the decedent stay with St. George CA and continue running the operation. The decedent did not like the buyer and did not like the idea of supervision. As a result, he refused the offer and the deal was scuttled. The buyer continued to issue letters of intent. Because neither he nor his attorney knew the true ownership of the companies, they were concerned that excluding or improperly ordering the brothers' names on the letters of intent would cause the deal to fail.

After the offer fell through, the decedent's brother proposed selling the companies to an ESOP. The decedent refused and the decedent's brother withdrew the proposal. In 2002, the decedent reconsidered keeping his role with the California companies secret and contacted St. George CA's bank about raising \$10 to \$20 million in order to buy out his brother. The decedent died before formally presenting the offer to his brother.

Discussion:

At issue for the Tax Court were the following:

- Did the decedent own an interest in any or all of the companies?
- Did his estate's failure to report such an interest on the estate tax return constitute fraud?

The IRS argued that the decedent owned either an uncertified or beneficial ownership interest for the following reasons:

- His development of business strategies.
- The fact that employees reported to him.
- His use of company funds for personal use.
- He held himself out as an owner or officer to customers and vendors.

The IRS asserted that the decedent would have been entitled to stock in the companies because he played a key role in the formation of the original companies. Statutes in California, Georgia, and New Jersey allow for the exchange of services for stock consideration. The estate argued that the decedent was not asked to be an owner when the company was initially founded, he did not intend to be an owner, and did not own an interest during his life. The estate further argued that although the decedent performed all the acts listed by the IRS, he was compensated financially for those services and thus was not trading services for equity.

Conclusion:

Courts in California, Georgia and New Jersey have all held that owning stock certificates is evidence, not determinative, of shareholder status. An owner of a corporation may not have certificates yet still be an owner. The cases cited by the IRS, however, were dismissed by the Tax Court because the individuals in the cases had intent to become shareholders and took action to achieve that intent. Further, in the IRS-cited cases, the companies desired to make the individuals shareholders. Because neither the decedent nor the companies intended to make him a shareholder, the cited cases were ruled inapplicable. The Tax Court also determined that the decedent had no financial incentive to be a shareholder. Additionally, the Tax Court ruled that he had no need to accumulate wealth to pass on, as he was estranged from his children and was not married. The ruling categorically rejected as unfounded speculation the IRS assertion that "Bobby would not have spent the rest of his life struggling to make [the companies] a success unless he was an equity owner."