GR Review

NEW TAX DEDUCTION LIMITATIONS ON CHARITABLE CONTRIBUTIONS

By Gerard Fellows

An individual taxpayer is generally able to take an itemized deduction equal to the fair market value of the clothing and household items contributed to an eligible donee organization. The deduction usually provides a benefit to the individual taxpayer by reducing their taxable income and the tax calculated thereon.

While considering new tax deduction limitations on charitable contributions, Congress noted that IRS statistics for the tax year 2003 show that the amount claimed for deductions for clothing and household items exceeded $9 billion. Congress also recognized the difficult tax administration issues inherent in the fair market value based deduction system for contributions of clothing and household items. In order to address some of these difficult tax administration issues, President Bush signed into law the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (the "Act") on August 17, 2006.

Under the Act, contributions of clothing and household items made after August 17, 2006 are subject to the following limitations:

(1) For an individual, partnership, or corporation, no charitable deduction is allowed for any contribution of clothing or a household item unless the clothing or household item is in good used condition or better;

(2) The IRS may issue regulations denying a charitable deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and undergarments; and

(3) Neither of the limitations apply to any contribution of a single item of clothing or a household item for which a deduction of more than $500 is claimed if the taxpayer includes with his return a qualified appraisal with respect to the property.

For purposes of the above limitation rules, the term "household item" includes: furniture; furnishings; electronics; appliances; linens; and other similar items. The term "household item" does not include: food; paintings, antiques, and other objects of art; jewelry and gems; and collections.

Congress expects that the IRS, in consultation with affected charities, will exercise its authority to disallow the deduction of some items of low value, consistent with the goals of improving tax administration and ensuring that donated clothing and household items are of meaningful use to charitable organizations.

Only Congress' broad policy statement above provides any guidance as to when clothing and household items will not be considered in

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A Newsletter from the Law Firm

GOULD & RATNER LLP

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Attorneys in the Spotlight

Fred Tannenbaum published an article for the Fall 2006 edition of *ACG International Magazine* entitled "Quarterly Status Update on Europe - Is a Scepter Still Haunting Europe?" Also published by **Fred** for *The Practical Lawyer*, American Bar Association, are his two articles, "The Second Half of Smart: How to Temper Your Intelligence and Become a More Effective Deal Lawyer" and "Subordinated Debt: The Missing Piece in the Puzzle." The Spring, 2007 edition of *The Practical Lawyer* will feature the following two articles written by **Fred**, "Venture Capital Issues in the U.S. and Canada" and "Venture Capital Issues in the U.S. and India." **Fred** also recently spoke at the Chicago Bar Association's forum on Venture Capital in the Theatre Industry.

Mark Leipold made a presentation regarding Director and Officer Liability: "Sources of Liability and Techniques to Limit Liability as it Relates to Insolvency and Bankruptcy" to the Professional Education Broadcast Network. **Mark** also participated in a panel discussion at the American Bar Association's Business Bankruptcy Fall Meeting in San Francisco on "Top Small Business Bankruptcy Issues." Mark and the panel discussed the issues faced by small and medium-sized companies in bankruptcy.

John Mays led a four part discussion series for the Urban Land Institute's Young Leader's Group. The discussions, each approximately two hours in length, gave young real estate professionals an attorney's view of development. The discussions included case studies and a site visit to Lennar's Parc Chestnut development on Franklin. **Michelle Selig** helped Karen Case, Executive Vice President of LaSalle Bank, lead another discussion group, titled "Real Estate Development Finance."

David Brown has been appointed to the Associate Board of the Arthritis Foundation, Greater Chicago Chapter. The Foundation's mission is to improve lives through leadership in the prevention, control, and cure of all forms of arthritis and related diseases affecting people of all ages.

John Washburn was recently elected Chairman of the Advisory Board of the Chicago College of Performing Arts at Roosevelt University, one of the premier music and theatre conservatories in the country.

At the annual meeting of The Civic Federation, **Ted Swain** was re-elected to the Board of Directors and the Executive Committee. Ted has been very active in the Real Estate Taxation Committee for many years.

Earnouts

By Fredric Tannenbaum, Partner

Parties to a sale or business transaction sometimes utilize earnouts or contingent purchase price provisions to solve valuation gaps. The buyer may only be willing to meet the seller's price if the seller's business performs after the closing at or above the level promised or hoped for. The seller, on the other hand, may be more willing to accept a lower nominal purchase price if it is confident that the business can attain specified post-closing performance goals.

While the theoretical rationale for earnouts is laudatory, their practical implementation sometimes is wrought with peril and invites post-closing uncertainty. This brief article highlights several of the key structural elements of earnouts and suggests means to protect both parties to minimize cost and controversy.

Metric for Determination. Will the seller share in some percentage of the post-closing increase or overall EBITDA level? Or will the earnout be tied to gross profit margins or some other metric? The determining metric is key from the standpoint of both valuation as well as integrity. From a valuation standpoint, a buyer may prefer an EBITDA threshold because that is strategic and long term oriented. A seller, in contrast, may only care about short term sales and therefore prefer gross revenues or gross profit as the benchmark. However, EBITDA is easily manipulated since the "e" component can be padded with extraordinary or simply elevated expenses which the seller would not have incurred when it controlled the business. While gross profit is not as easily subject to manipulation, many clever but justifiable means exist to deflate this figure as well. Parties need to devise elaborate adjustments to their formulas to increase earnings or revenues by unusual expenses or discounting. Further, the parties need to separate any extraneous buyer operations or overhead from the earnout calculation. Metric determination provisions are therefore the subject of intense negotiating. Precise and careful drafting is key to minimizing if not eliminating disputes.

Security for Payment. A buyer may have already leveraged the assets of the business to finance the purchase price and a seller may not receive sufficient comfort with a second security interest in the collateral. Further, a senior lender will frequently restrict payments to a junior lender and certainly prohibit them if there is a default. Moreover, situations often arise where the appropriate targets are met and earnout exceeded, yet the buyer has insufficient cash flow, whether due to taxes, bank restrictions, working capital timing or re-investment. Therefore, sellers often insist on third party guarantees and other collateral to assure the integrity of the payment of the earnout.

Events for Acceleration. The period in which the earnout may be made is of limited duration. However, if the buyer's business is sold prior to the ending point for determining earnouts or the seller is unjustifiably terminated (assuming the seller has remained as a key employee of the buyer), the seller will be deprived of an opportunity to actually earn the earnout. The buyer, on the other hand, might claim that the earnout would not likely have been met or that it terminated the seller since he or she was not performing. Therefore, the parties need to anticipate some form of acceleration of the earnout to deal with these contingencies.

Events for Withholding Payment. A buyer will occasionally refuse to pay amounts due under an earnout and insist on an offset due to a good faith belief that seller has breached one or more of its representations and warranties under the purchase agreement or seller owes some amount under another agreement such as a lease or supply agreement. The parties should negotiate an appropriate means to assure the buyer that it is not needlessly paying such sums while at the same time preventing mischief. Paying the earnout to a third party escrow pending resolution of the dispute is one means to assure the integrity of the process.

Dispute Resolution. Carefully drafted dispute resolution provisions are key to minimizing cost and time as well as preventing extraneous issues from polarizing the parties or needlessly harming the business or its relationship with key employees, customers, vendors, and financing sources. While independent accounting firms often serve as the arbiter of these disputes, the accountants must be carefully guided to enable them to accurately and clearly implement the parties' intent. Can the accountant offer a figure not proposed by a party? Can the accountant use a different methodology? Will the accountant understand some of the terms it is being asked to judge? If the person resolving the dispute is not pre-

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COURTROOM HIGHLIGHTS

Gould & Ratner LLP litigation partners **Bob Carson** and **Ted Kommers** successfully defended a $16 million-plus suit in the U.S. District Court in Chicago on behalf of Ring Power Corporation, a Florida-based distributor of industrial and commercial diesel power generators. A customer, Indeck Power Corporation, based in Wheeling, Illinois, claimed that 24 semi-trailer mounted diesel generators it had purchased and accepted from Ring Power did not meet the contract specifications, and further claimed that the contract was induced by an intentional misrepresentation. In a September 14, 2006 opinion entered after a six day bench trial, U.S. District Judge Coar found the equipment met the contract specifications, there was no misrepresentation, and the purchaser received exactly the equipment it had ordered. The court entered judgment exonerating the defendant on all claims. Gould & Ratner also recovered a portion of the defense costs and attorneys' fees for its client.

Chris Horvay and **Christina Conlin** obtained dismissal of a Chapter 11 bankruptcy proceeding filed by an Illinois limited liability company. On behalf of individuals holding liquidated claims against the debtor, **Chris** and **Christina** argued that the Chapter 11 petition had been filed in bad faith because the debtor lacked any legitimate creditors other than Gould & Ratner's clients.

Mark Abraham obtained summary judgment on behalf of a corporate real estate purchaser who filed a declaratory judgment action seeking a judicial determination that it obtained title to a commercial property free and clear of any and all liens, including Illinois tax liens. A Gould & Ratner client purchased the subject property at a bankruptcy auction that was <None>confirmed by the United States Bankruptcy Court for the Northern District of Illinois. Cook County subsequently sold the property at a Tax Deed Scavenger Sale to a third party. **Mark** convinced the Circuit Court that Cook County had no authority to sell the property as the tax liens had been discharged from the property. The Circuit Court declared the tax deed sale to be void and confirmed that Gould & Ratner's client owned the property free and clear of the subject liens.

Bob Carson and **Mark Abraham** successfully obtained a ruling from the Circuit Court setting aside a multi-million dollar derivative arbitration award entered by the American Arbitration Association in a securities case. The court agreed with Gould & Ratner's position that the arbitrators committed gross errors of law by failing to require the claimant to establish causation and in improperly treating the defendants as guarantors of the investments. The court remanded the case to the American Arbitration Association for rehearing.

Bob Carson and **Mark Abraham** recently obtained a decision from the Illinois Appellate Court affirming the trial court's favorable summary judgment ruling in a commercial litigation matter based on a claim of unjust enrichment.

Over a year ago, **Chris Horvay** and **Mark Abraham**, on behalf of a client tire distributor, successfully annulled an automatic stay in a Chapter 13 bankruptcy proceeding. Following an evidentiary hearing, the court adopted Gould & Ratner's position in the case and retroactively validated four years' worth of collection work by the client, despite the then existing automatic stay. On November 27, 2006, **Chris** and **Mark** again successfully represented the client in a subsequent Chapter 13 bankruptcy proceeding (involving the same debtor) and obtained a ruling (after another evidentiary hearing) that the Chapter 13 debtor filed the new bankruptcy case as to Gould & Ratner's client in bad faith based on Section 302 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") which was designed to prevent serial bad faith filers from unlawfully utilizing the bankruptcy system and the automatic stay to the detriment of creditors.

On October 12, 2006, **Chris Horvay** and **Mark Leipold** confirmed the successful Chapter 11 reorganization of our client which was the owner of the Holiday Inn Schaumburg. After the Chapter 11 plan was confirmed, the hotel property was sold pursuant to the Plan and **Mark** and **Claudia Bruno** completed the closing of the sale.

ATTORNEYS IN THE SPOTLIGHT (CONT'D)

Virginia Harding moderated a seminar presented by the Professional Education Broadcast Network on "Common Ownership: Condominiums and More." Over 150 attorneys throughout the United States participated in the dial-in teleconference. **Virginia**, a founding member of the Illinois Real Estate Alumni Forum, took the lead in making the Forum's First Annual Monopoly Night a reality. 150 attended to network and play the "game." Proceeds from Monopoly Night will help establish a Chair in Real Estate for the University of Illinois' College of Business.

Gerald Ratner made a gift of $1,000,000 in November to the University of Chicago Law School as the first installment under a Gift Agreement for $5,000,000 to establish at the University of Chicago Law School the "Gerald Ratner Distinguished Service Professorship of Law."

Howard Turner updated the following chapters in **Mechanics Liens In Illinois** published by the Illinois Institute of Continuing Legal Education for the 2006 Publication: Chapter 4 Subcontractors; Chapter 9, Trial Practice, proof of selected issues; and Chapter 10 Damages. **Howard** also recently prepared a supplement for the Illinois Institute of Continuing Legal Education's publication **Illinois Construction Law** for Chapter 2 on Contract Formation and he is updating his chapters in IICLE handbooks for Mechanics Liens and Construction Law. The revised handbooks should be published in 2007.

Gould & Ratner welcomes Partner Richard Reizen and Associates Mark Brookstein and Michael McCann

Richard Reizen concentrates his practice on the representation of individuals and entities in commercial litigation, including construction, financial institution, telecommunications, corporate, professional malpractice, securities, equipment lease, and contract disputes. He joins Gould & Ratner from Kubasiak, Fylstra, Reizen & Rotunno PC.

Mark Brookstein focuses his practice in the area of commercial litigation, including complex matters involving corporate securities and fraud, labor and employment, and professional malpractice claims. He joins Gould & Ratner from Mayer, Brown, Rowe & Maw LLP.

Michael McCann concentrates his practice in the areas of corporate law and transactions, including mergers, acquisitions, private securities offerings, and corporate finance matters for privately held enterprises and family business entities. He joins the firm from Wildman, Harrold, Allen & Dixon LLP.

NEW TAX DEDUCTION LIMITATION ONRETALIATION CHARITABLE CONTRIBUTIONS (CONTINUED)

"good used condition or better" so as to bar a deduction under rule (1) above.

The IRS has provided guidance on the valuation of donations made prior to August 18, 2006. For donated clothes, the price paid by buyers of used items in used clothing stores, such as consignment or thrift shops, is an indication of value. For used household goods, it says that the value of those items is usually considerably lower than the price paid when new, and that frequently that property has very little or no value due to its worn-out condition and the fact that it is obsolete because of style or utility.

Therefore, taxpayers may still receive an itemized deduction equal to the fair market value of contributed clothing and household items if the item has greater than minimal monetary value and is in at least good used condition. These new charitable contribution limitations continue to emphasize the importance of taxpayers maintaining accurate and complete records to document the deductions taken on their returns.

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EARNOUTS (CONTINUED)

selected and therefore able to read and accept the contract language in advance, the parties need to involve their accountants at the drafting stage to obtain their imprimatur.

In conclusion, earnouts often solve valuation differences but, at the same time, cook up a recipe for further confrontation. If parties feel they really need an earnout, they need to carefully address these critical areas.

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REIT TO BE INTRODUCED IN GERMANY RETROACTIVELY AS OF 1 JANUARY 2007

By Dr. Henning Klingenfuß
Zirngibl Langwieser
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The German Real Estate Investment Trust (G-REIT) is to be introduced in Germany. The law will very probably be adopted at the end of March and will come into force retroactively as of 1 January 2007.

The G-REIT will be exempted from all corporate taxes if certain conditions are fulfilled. These conditions include the following:

- The G-REIT must take the legal form of a corporation listed on the stock market *(Aktiengesellschaft)*. A free-float of 15% (25% at the time of the initial public offering) has to be ensured.

- Each shareholder's direct share in the G-REIT must not exceed 10%. An indirect share of more than 10%, however, is expressly permitted.

- The G-REIT is obliged to distribute at least 90% of its distributable profit.

- At least 75% of the G-REIT's assets must be real property. At least 75% of the gross income must be income from rent, lease and sale of real property.

- Existing residential property built prior to 1 January 2007 is excluded from the scope of G-REITs. Any residential property built after such date is eligible for G-REITs without restrictions. Residential property means such property of which 50% of the usable floor space is used for residential purposes. Hybrid use property is therefore eligible for G-REITs. The question whether or not residential property can be included in a G-REIT has been discussed controversially. The reason for such restriction is socio-political issues, in particular protection of tenants.

- Debt financing must not exceed 60% of the total financing volume.

- During a period of five years, the G-REIT must not sell more than 50% of its average real property holdings.

- For real property included in a G-REIT, a so-called exit tax (tax benefits for the disclosure of hidden reserves) for a valuation of 50% of hidden reserves for a period of three years is introduced. This is to enable German companies to mobilize their real property holdings and at the same time make use of this tax benefit, as in Germany a large number of companies are, for tax reasons, still owner-occupiers of their real property holdings to a larger extent as is usual internationally.

- The G-REITs may comprise both domestic and foreign real property. Foreign real property may also be held indirectly via a foreign special purpose vehicle.

Income from G-REITs will be treated as income of the investor and taxed according to his personal tax situation.

The introduction of G-REITs will strengthen the German financial market, especially the German real estate market. Due to the high dividend payout ratio, investors expect exceptionally high returns on investment from G-REITs.

Zirngibl Langwieser has offices in Munich, Germany. If you have any questions, please contact Mr. Klingenfuß at h.klingenfuss@zl-legal.de.

Zirngibl Langwieser is a member of LawExchange International, a group of law firms from commercial centers around the globe. Gould & Ratner is also a member of LawExchange International.