Insights on VALUATION

3RD QUARTER 2012, VOLUME III

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Dollar Value Formulae Ease the Risk of Gifting

One of the significant risks of making a gift of a business interest to one's child or trust is the possibility that the Internal Revenue Service will audit the gift tax returns and raise the value of the gift. This could produce an unexpected tax liability. Many a client is afraid to get close to their unified credit equivalent. But two recent cases show a way to eliminate this risk. These cases are *Petter* and *Wandry*:

Estate of Petter v. CIR,
108 AFTR 2d 2011-5593

Joanne M. Wandry, et al. v. CIR,
TC Memo 2012-88

Petter was a 2009 tax court decision, recently heard on appeal at the Ninth Circuit. The decedent had made transfers of units in her family limited liability company simultaneously to a family trust and to a charity. She defined the transfer as a specific number of units in total, but the number of units going to the family trust was defined as a specific dollar amount of the total units transferred. For example, she transferred to the trust that number of units equal in value to $1 million, and the balance of the units, whatever that number may be, went to the charity. The value per unit was defined as the value "as finally determined" for gift tax purposes.

For the gift tax and income tax returns, the value per unit was determined by appraisal, which incorporated discounts for lack of control and marketability. The transfers to both parties also provided that, if the per unit value "as finally determined" is found

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A caveat about gifting: state law defines a completed gift. It usually requires intent, delivery and acceptance. Please be sure to check the minimum requirements in your state to assure that a completed gift occurs.

not to be the appraised value, either the trust will give additional units to the charity or vice versa, so that the total dollar value of the units going to the trust stays the same.

Upon examination, the Internal Revenue Service (the Service) concluded a higher value per unit. The taxpayer and the Service later stipulated to a higher value per unit, significantly higher than the appraisal value. The differential, according to the Service, gave rise to a taxable gift. The taxpayer disagreed, arguing instead that the dollar amount of the transfer to the trust was unchanged; it was the number of units going between the two recipients that changed. Not only was there no additional gift, there was an additional charitable contribution to deduct on her income tax return.

The tax court sided with the taxpayer, and the Ninth Circuit agreed. There is a difference, they said, between a value formula clause and a "condition precedent." A "condition precedent" is an event that must occur before a transfer becomes effective. Gifts subject to a "condition precedent" are not recognized as transfers for tax purposes.

The Service took the position that the final number of units going to the family trust and the charity could not be determined until the conclusion of their exam, so their exam was a "condition precedent" to the transfer, at least with respect to the number of units moving from the trust to the charity. The court said "as finally determined" means the value on the tax return unless the Service successfully challenges it. In fact, the value "as finally determined" could change as a result of a civil suit or other proceeding among the parties that redefines it.

In this case, said the court, the value formula was unequivocal as to the intended amount of the transfer to the family trust, and the Service's exam did not enable the transfer. The trust was entitled to receive a specific total dollar value of units as of the date of the transfer, and the refinement of the dollar value per unit, though well after the date of the transfer, served merely to clarify the correct number of units transferred to each recipient.

The court also differentiated *Petter* from *Proctor* (*CIR v. Proctor*, 142 F. 2d at 827). In this case, the formula clause said:

> *"In the event … any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that…the excess property…which is decreed by such court to be subject to tax, shall automatically be deemed not to be included in the conveyance…"*

The Fourth Circuit found this clause to violate public policy because any attempt to collect the tax would defeat the gift. Contrast this with *Petter*'s formula, whereby the gift is not defeated.

Wandry took the argument one step further. No charity recipient was involved. The taxpayer transferred member units in the family LLC to her children and grandchildren, specifying the dollar value of each transfer, but not the number of units. For example, she gave $261,000 worth of member units to each child, with the number of units dependent on the per unit value. The assignment specifically stated:

> *"Although the number of units is fixed on the date of the gift, that number is based on the fair market value of the gifted units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service. I intend to have a good-faith…[appraisal]… Nevertheless, if…a final determination of value is made by the IRS or a court of law, the number of gifted units shall be adjusted…."*

The Service again argued that the gift was subject to a "condition precedent", and the higher value per unit now finally determined should result in a taxable gift. The tax court disagreed, pointing to *Petter*. The final determination of value per unit served merely to clarify the number of units transferred.

While there is still some room for the Service to continue attacking dollar formula gifts, it certainly makes sense to define gifts of business interests in dollar amounts rather than units, shares, or percents of ownership. If the *Petter* line of cases holds up in the long run, taxpayers will have reduced their risk on audit. If the reasoning eventually falls by the wayside, the taxpayer will be no worse off than before. We will continue watching this development.

Valuation and Shareholder Disputes

As some wag once said, a business partnership is like a marriage without any of the benefits. And just as husbands and wives get divorced, so, too, do business partners, which necessitates that the jointly-owned business be valued before the owners can go their separate ways. The typical shareholder dispute is triggered by two basic causes of action known as dissenter's rights and shareholder oppression.

When a minority shareholder disagrees with the direction that the majority shareholder is taking the company, that minority shareholder can dissent from voting for a particular proposal. Typical proposals put forth by the majority shareholder that fail to garner the consent of the minority shareholder(s) are mergers, sale of assets, or some other major change to the nature of the business such that the minority shareholder finds himself squeezed out of the business.

Flagrant acts of minority shareholder abuse are found more often in oppression cases than dissension cases, where minority shareholders are treated unfairly or prejudicially by the majority shareholder or the board of directors. As oppression cases often involve minority shareholders who are also employees of the company, they can involve termination of either dividends or compensation or employment, or all three together. Another form of shareholder oppression occurs when the majority shareholder draws off corporate assets to his own benefit in the form of excess compensation, non-operating assets such as corporate toys in the form of boats

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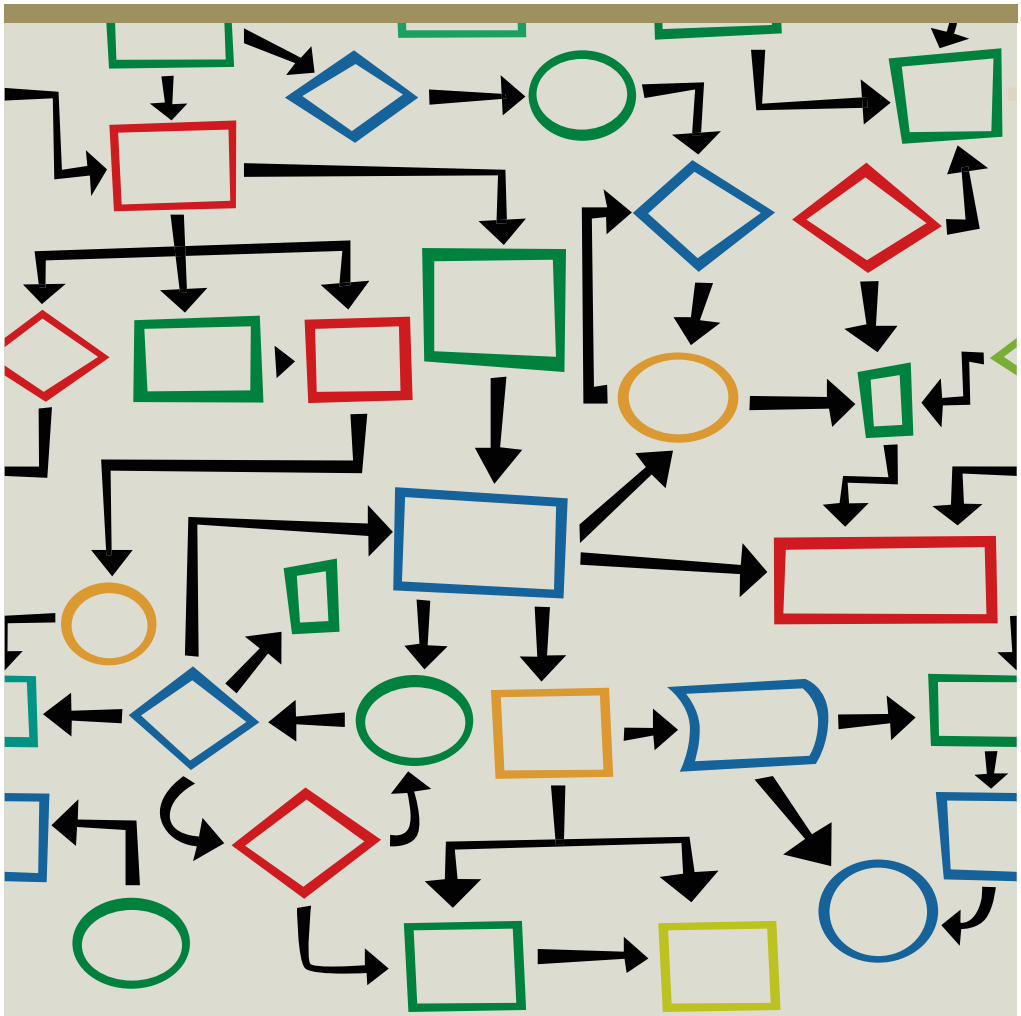
or airplanes or camps, family members on the company payroll, etc., all to the detriment of the minority shareholder.

As a remedy for both dissenting and oppressed minority shareholders, if state statutes allow it, they may petition the courts to dissolve the corporation in order to recoup what the majority shareholder has gained at their expense. Another remedy is to have the company elect to buy their shares or have the courts order it to do so, if allowed for by state statute. But no matter what remedy is chosen or enforced, the ultimate question is: at what value?

When minority interests in a closely-held business are valued for the purposes of estate or gift tax filings or matrimonial divorce proceedings, the standard of value is fair-market value. This means that minority interests are subject to discounts from control value for their lack of marketability—the inability to put either the whole company up for sale or the ability to find a buyer for their own shares, lack of liquidity—the inability to monetize their shares in a relatively short period of time, and lack of control—the inability to influence company decisions. However, for dissenting and oppressed shareholders, in most jurisdictions, the standard of value is fair value.

Fair value is widely understood to mean the proportionate share of the value of the company as a whole, or fair-market, value on a control basis without any discounts. Most jurisdictions comply with this definition and have interpreted fair value to be a pro rata share of the entity-level value of a business rather than the fair-market value of the individual minority shares themselves. For small, closely-held business where the shareholders are the key employees, this makes sense as a departing shareholder wants and expects to receive 100 percent of the fruits of his labor, just as he would have if he was still around when the company was sold.

For anyone involved in a shareholder dispute, the valuation analyst that you engage will value your company as a whole using proper valuation techniques, including the use of entity-level adjustments necessitated by the impact on cash flows of the actions of the majority shareholder. The final determination of fair value and the subsequent cash payout to the dissenting or oppressed shareholders will be determined by individual state statutes and case law based on the facts and circumstances of each given case.



The Process of Business Valuation

As every business valuation contains its own unique character, the process of completing a business valuation is far from being a "cookbook" formula. However, the development and writing of each and every business valuation report does contain some common elements. This article will outline the steps generally found in the development of a conclusion of value.

The first step in the business valuation process is typically the most difficult, and that is laying the foundation for the business valuation by *information gathering*. Financial and operational information about the business, the economic and industry environment, the markets and market data; all are necessary to support the risk assessment of an ownership interest in a business and, subsequently, its value. The valuation analyst will certainly need to know the *nature of the subject interest* they will be valuing; is it a controlling or non-controlling (i.e., minority) interest? Is the subject interest to be valued on a marketable or non-marketable basis? Another key element in this first step is the determination of the *purpose for the valuation*. The purpose will drive the particular standard of value to be used. For example, valuations for tax purposes, i.e., gift, estate, or charitable contributions, are required to be performed using a *fair market value* standard of value while valuations for potential purchases or sales of a business generally will be performed under an *investment value* standard of value. Incorrectly substituting one standard of value for the other could easily result in an incorrect conclusion of value.

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Once the foundation has been laid through the information gathering process, step two involves the financial and operational analysis of the business and the related comparison of the business to its peers in order to determine whether the business represents a greater or lesser investment risk than other, similar businesses in the industry. This step can be very time intensive based on the type (i.e., audited financial statements, tax returns, internally-prepared financial information, etc.) and condition of the business' financial records.

The third step in the process is the determination by the valuation analyst of the most appropriate approach and methodology to estimate the value based on the analysis performed in step two. Each of the three approaches to valuation—*asset*, *income*, and *market*—should be considered in every conclusion of value. An *asset approach* is generally used when valuing a controlling interest or under liquidation premise of value, and the valuation analyst will adjust the assets and liabilities on the business' balance sheet to their market values. If an *income approach* is the most appropriate, the analyst will need to define the appropriate benefit stream and calculate an appropriate discount or capitalization rate. If a *market approach* is being considered, the valuation analyst needs to determine if he or she has a sufficient number of comparables, in terms or either publicly-traded companies or transactions data, in order to develop a reasonable price multiple to apply to the subject business.

Once the value has been calculated using a suitable approach and methodology, the next step is the consideration of *applicable adjustments* to that calculated value. Since each approach to valuation relies to some extent on public market data to calculate a value, adjustments are necessary to reflect the value found in a privately-held entity. The two most typical adjustments of this nature include a discount for lack of control (applied to a non-controlling, i.e., minority interest) and a discount for lack of marketability to reflect the inability to readily convert an ownership interest in a privately-held business to cash as compared to a publicly-traded ownership interest.

Finally, once the valuation analyst has calculated a value and made any appropriate adjustments, the final step is performing a *reasonableness test* to that value. This involves taking a step back and looking at the overall valuation determination and possibly performing "sanity checks," making sure that the indicated value is supported by the business' financial performance and a comparison to similar alternative risk-related investments.

As mentioned at the outset of this article, each and every business valuation is unique and the process for an individual valuation may include elements of analysis not specifically mentioned here, but in valuation theory, there is a commonality of the overall process found in every valuation engagement.

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