

PO BOX 655
 1 EAST STATE ST
 SHARON, PA 16146
 (724) 346-0150

The Business Value Manager

Transfer Wealth at Discounted Values to Minimize Estate and Gift Taxes and Maximize Wealth

Advice for business owners, investors and service providers on how to build value and wealth through investment in closely held companies.

The stories are legendary - or infamous if you really ponder them - of the entrepreneur who builds the family business and then upon his or her death, the decedents' estate is forced to sell the company to pay estate taxes. The lesson to be learned from this is simple: Transfer wealth (but not necessarily control) of your private company at discounted values to minimize the government's take and maximize your wealth.

Many tax planning techniques exist to accomplish this goal, and among the more sophisticated are creation of multiple entities that reduce the attractiveness - and the value - of the transferred asset.

Such an ownership structure can cause multiple layers, or tiers, of valuation discounts applicable to minority interests in entities which in turn own minority interests in other entities. The development of these tiered entities, however, requires careful planning. For discount valuation purposes, the form of entity - corporation, partnership, limited liability company, etc. - is generally irrelevant.

Assume that the Jones Family Limited Partnership ("Jones") owns limited (and therefore minority) interests in Partnerships X, Y and

Z, each of which respectively owns income-producing real estate. For valuation purposes:

1. The X, Y and Z limited interests should be valued at discounts from the value of the underlying real estate. This is *not* controversial.

2. The Jones limited interest should be valued at an additional discount. This *is* controversial.

The magnitude of the discounts are determined based on the lack of control

and lack of liquidity characteristics of each entity. These in turn depend on the nature of the assets owned, their income generation, their liquidity, their appreciation potential, and the valuation-related provisions of the relevant entity agreements.

The most common objection that some make to tiered discounts is that they "double-count" the diminution in value created by the ownership structure. This opinion, however, is not necessarily cor-

"...family wealth can be sheltered from a government eager to take it, but care must be taken to structure the portfolio to achieve tax minimization.."



(Continued on page 2)

ONE STOCK, THREE VALUES

"Your value of \$40 million for our stock can't be right," said the company's CFO. "We know it's worth at least \$50 million, and we know our biggest rival would pay \$60 million just to take us off the market."

The CFO was wrong about the \$40 million, but could be right about both the \$50 and \$60 million. The \$40 million reflects the fair market value of the stock without control or marketability, while the \$50 million could reflect the added value created by control and increased marketability. The \$60 million could be investment value to a strategic buyer due to synergies. Multiple values for the same stock, as of the same date, usually exist. Wise investors calculate these values on an ongoing basis to assess the optimum time to cash out.

(Continued from page 1)

rect. Consider the following:

- ◆ To access the value of the underlying real estate assets, owners of Jones limited interests must breach at least two entities - The Jones Family Limited Partnership and then either X, Y or Z Partnership. Jones limited interest owners thus suffer a more pronounced lack of control than would direct owners of X, Y and Z partnership interests. So there is no double-counting of the lack of control.
- ◆ The lack of liquidity of the Jones FLP interests is bigger than that of the X, Y and Z interests owned directly. First, X, Y and Z's assets must be sold and those entities liquidated, with the proceeds flowing into Jones. This creates the discount for lack of marketability at the X, Y, and Z level. But the liquidity of the Jones limited interests is still impaired, even though Jones is liquid, because there is a limited market for the Jones interests.
- ◆ The argument that the limited interests of Jones and X, Y and Z have the same lack of control and lack of liquidity characteristics is self-contradictory and illogical. It assumes and concludes that one of these entities is irrelevant and has no effect on value. This cannot occur if the partnerships are properly structured and administered.

The use of tiered discounting is controversial because of IRS concern that a taxpayer might create multiple entities and attempt to pile discounts on top of discounts to lower taxable values - with no end in sight. For example, assume that a taxpayer wants to gift 10% of his \$5 million marketable securities portfolio to his daughter. A straight gift of 10% would be worth \$500,000. However, if he puts the \$5 million into a separate entity and uses a 30% overall lack of control/lack of marketability discount, the value of the 10% gift drops to \$350,000 (\$500,000 minus \$150,000 equals \$350,000).

The same taxpayer could effectively gift 10% of the \$5 million portfolio to his daughter at an even lower value by using more than one entity with additional discounts being applied at each stage. It is possible to use enough entities and discounts to bring the value of the gift to zero, which would be an obviously ridiculous result. Any use of multiple entities and multiple discounting must produce results that are economically reasonable. A qualified, experienced business appraiser can determine the reasonableness of the result based on the total return of the investment.

The issue of tiered discounts was addressed in the U.S. Tax Court in *Gow v. Commissioner, TC Memo 2000-93*. At issue in that case was the fair market value of minority blocks of stock in a corporation that owned one third of a joint venture interest and the minority blocks of corporate stock should be discounted for lack of control and lack of marketability. The court decided that a 15% lack of control discount and a 30% lack of marketability discount were applicable to the joint venture interest. The court also allowed 20% to 30% lack of control discounts and a 30% lack of marketability discount for the minority blocks of stock.

Given the opportunity for value manipulation, we expect the IRS to continue to scrutinize tiered discounting and attempt to put limits on it. With proper advice and planning, though, family wealth can be sheltered from a government eager to take it.

Standard of Value Matters in Valuations for Litigation

Litigation, including matrimonial dissolution disputes, frequently deals with the issue of whether a business interest should be worth "fair market value" or "fair value". These terms are often used interchangeably in conversation, media reports, accounting regulations, and, unfortunately, in courts.

Valuation standards have different meanings, which can lead to large valuation differences:

- *Fair Market Value* most often applies to tax-related valuations. It is defined by IRS Revenue Ruling 59-60, many other rulings and much case law. It assumes *hypothetical third-party* buyers and sellers of the interest being valued.
- *Fair Value* applies to dissenting (minority) shareholder disputes. It is defined statutorily by each state. It involves *actual current shareholders* transacting the interest to be valued.

"The bottom line is: fair market value involves transactions with hypothetical third parties and recognizes adjustments for degrees of liquidity and control, while fair value involves transactions with actual shareholders and usually computes value on a control basis."

Two of the major differences between these standards are:

- *Treatment of discounts for lack of control and lack of marketability.* Fair market value considers them, adjusted for case facts and circumstances. Fair value may or may not allow them, depending on state statutes, and fair value frequently requires a minority interest to be valued on a control basis.
- *Consideration of specific buyers and sellers.* Fair market value envisions generic "financial buyers" who bring only cash and management of equivalent capability. Fair value, depending on its definition, could conceivably involve "strategic buyers" (or sellers) who possess unique value-enhancing characteristics, often called "synergies."

Matrimonial litigation is complicated by the lack of uniform federal/state statutes which stipulate whether fair market value or fair value applies. Each state, jurisdiction, and trier of fact exercises discretion. As a result, case law is inconsistent, and has blurred the distinction between these two standards of value. This creates the potential for confusion and

debate in many divorce cases. The adoption and enforcement of a uniform standard of value for divorce litigation would remedy that, but creation of such a system is highly unlikely.

The bottom line is: fair market value involves transactions with hypothetical third parties and recognizes adjustments for degrees of liquidity and control, while fair value involves transactions with actual shareholders and usually computes

value on a control basis. These are fundamentally different value premises which should not be, but often are, confused.

The standard of value selected can create a huge effect on the value conclusion. Consider these definitional issues carefully before engaging in litigation, and be sure to understand their applicability to that case. In the process, carefully assess

your valuation advisor. He or she should be familiar with these issues, and should possess experience as an expert witness on these matters.

FIRST STEPS

To manage your business as an investment and take control of your life:

- Retain qualified valuation advisors to lead the process.
- Identify and prioritize your personal and financial goals.
- Quantify
 - Your company's return
 - Your company's risk
 - Your company's worth
 - Your company's return on investment

RESULT:

Armed with the information, you can devise the best strategy to achieve your business, personal and financial goals.

Reproduction is prohibited without permission..

EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

P.O. Box 655
One East State Street
Sharon, PA 16146

Phone: 724-346-0150

Fax: 724-342-4510

fevans@evansandassociates.net



Frank C. Evans
ASA, CBA, CPA/ABV
fevans@evansandassociates.net

Visit us on the Web!
www.evansandassociates.net

Our Mission

Evans and Associates is a leading provider of strategic valuation advisory services. We maximize wealth and profits for individuals and corporations.

When your circumstances require measurement or management of business value, our focused approach provides solutions.

Our team's expertise in competitive analysis, finance and accounting, merger and acquisition, risk analysis and value creation forms the basis for our opinions and advice.

Typical engagements for Evans and Associates include specialized valuation consultation for the purpose of gift or estate planning, merger and acquisition, shareholder value enhancement and litigation support.

Evans and Associates Partner Credentials Include:

Accredited Senior Appraiser
Certified Business Appraiser

Certified Public Accountant Accredited in Business Valuation

Personal Attention Backed by a Network of National Resources

Evans and Associates is a specialized valuation advisory firm small enough to provide the personal attention you want, but deep enough to possess the broad range of service expertise you may need. Our membership in the American Business Appraisers (ABA) national network— we were the founding affiliate member—provides resources and advice from other nationally known valuation experts. Our ABA affiliation enables us to effectively execute virtually any valuation or merger and acquisition assignment.



AMERICAN
BUSINESS
APPRAISERS
NATIONAL NETWORK