

Business Valuation Notes

Minnesota Business Valuation Group - 2675 Long Lake Road, St. Paul, Minnesota 55113-1117

Telephone 800 303 2889 or 612 240 0309 Fax 612 677 3881 www.BusValGroup.Com

Volume 9, Issue 3

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Mar. 2009

Don't Expect Limits to Value...

BUY-SELL AGREEMENTS

...IRS Looks at Terms

Documenting buy-sell agreements between and among shareholders and other equity partners in private businesses will not guarantee a particular price or value which is binding for tax purposes. Use or misuse of this tool is timely with clients, lawyers, and accountants now in the maelstrom of tax season.

David Naples, a Mankato, Minnesota, based lawyer with Leonard, Street, and Deinard, recently pointed to the Internal Revenue Service (IRS) Treasury Regulation § Section 20.2031-2 regarding the impact of a buy-sell agree-



Naples

ment on the estimated tax value of a business interest. It states "little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime."

Joel Grundmeier, (CPA, MST, CFP) (Tax Manager, Estate, Fiduciary, Gift and Individual Tax Planning /

Compliance) is a certified business appraiser (CVA) for the Minnesota Business Valuation Group. Grundmeier said that Olsen Thielen & Co. (the holding company of MBVG) does the accounting for several estates and trusts and reviews many buy-sell agreements, which some lawyers believe should 'cap' the value. "Most of the buy-sell agreements we see," Grundmeier says, give the right of first refusal to a close group of people, but they provide that the hopeful selling investor may go outside the group to try for a better offer.



Grundmeier

"If there is a better offer, the group may purchase the interest at that price or better, but if the inside group chooses not to buy at that price, then the interest can be sold to an outside buyer at the higher price. The new buyer usually must, of course, still agree to abide by all of the other terms which govern the relationship of the inside group."

Naples points out that under the terms which Grundmeier outlined because
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ESTATE TAX BILL MAY INCREASE GIFTING TAX

DEBATE ABOUT DISCOUNTS

The first bill of the year to address estate tax reform is titled as tax relief but presents a possible tax increase for family gifting. The 111st Congressional House of Representatives (H.R.) bill could reestablish "family attribution" so that all fractional interests in family-controlled entities would be deemed "controlling interests", according to interpretations of the provision. As such, there would be no discounts for lack of control and lack of marketability for these family-controlled entities.

Minnesota Business Valuation Group Senior Business Appraiser Laurel Sorensen, CPA, ABV, said that if the change is adopted, it could eliminate most discounts for gifting



Sorensen

closely held minority interests of family businesses and other holdings in Family Limited Partnerships and similar entities. Estate planning vehicles, such as FLPs, have become popular for transferring interests to children.

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POMEROY

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If the law is changed, it could suddenly result in large tax increases and decrease the attractiveness of those vehicles, according to Sorensen.

The controversial legislation is H.R. 436, "Certain Estate Tax Relief Act of 2009" which was introduced in early January by North Dakota Congressman Earl Pomeroy (D). For gift and estate tax purposes, the bill would disallow lack-of-marketability discounts for non-business assets when there is a transfer of an interest in an entity that is not publicly traded. Sorensen said that the bill defines a non-business asset as an asset that is not used in the conduct of a trade or business.

American Society of Appraisers (ASA) Government Relations Committee Vice Chairman William Fraser wrote in a Special Report from *Business Valuation Update*TM for the



Fraser

March 2009 issue that the family attribution was repudiated in 1981 in United States Court of Appeals court decision regarding the *Estate of Mary Frances Smith Bright v. U.S.*, and that the notion of treating family closely held minority interests as controlling

interests was abandoned by the U.S. Internal Revenue Service in Revenue Ruling 93-12 in 1993. "The Pomeroy Bill is an end run around the judicial and regulatory prohibitions against family attribution," Frazier wrote.

Frazier is Senior Managing Director and an owner of Howard Frazier Barker Elliott, Inc., principally a general investment banking firm with two regional firms in Houston, Texas. He is a supervisor who participates in valuations, financial advisory opinions, and corporate finance.

The curious inclusion of the provision which could adversely effect family estate planning is contained in a bill which on the surface is "To amend the Internal Revenue Code of 1986 to repeal carryover basis rules in order to prevent tax increases and the imposition of compliance burdens on many more estates than would benefit from repeal, to retain the estate tax with a \$3,500,000 exemption, and for other purposes." The legislation would be effective after December 31, 2009.

Frazier contends that the IRS and some legislators believe that taxpayers abuse family limited partnerships, "making the FLP nothing more than a device to escape estate taxes."

MBVG President Randall Schostag said that over the years there have been many IRS attempts to limit taxpayers' use of FLPs and similar entities, most notably claiming that they had no business purpose but were, rather, only designed to reduce taxes.

Frazier argues that the Pomeroy Bill's changes do not consider the IRS requirement to develop a Fair Market Value estimate of value from the perspective of a hypothetical willing buyer and a hypothetical willing seller.

"If implemented, the valuation rules of the Pomeroy Bill would violate numerous sections of the Internal Revenue Code and many Revenue Rulings," Frazier wrote.

Schostag said, "We think that Mr. Frazier has it right. It's amazing how often the government passes legislation which is inconsistent with



Schostag

other legislation already on the books. It's frustrating for clients, appraisers, and accountants."

Frazier wrote, "The valuation discount provisions ... are an over reaction to the problem and its proposals do far more harm than good. In addition, the tax dollars it seeks to recover for the Treasury are now illusory."

Further information is available at <http://www.BVResources.com>, "Appraisals for Tax Purposes: Collateral Damage of the 'Pomeroy Bill'."

Business Valuation Resources, LLC (From the developers of Pratt's Stats[®]), publishes *Business Valuation Update*TM monthly from Portland, Oregon, on an annual subscription basis. The chairman and chief executive is David Foster: (503) 291-7963.

Buy-Sell

(Continued from page 1)

there is no ceiling on the price during the holder's lifetime. The buy-sell agreement may not establish the estate tax value so the value for an estate is the fair market value which could be different than the price in the buy-sell agreement.

"The price set by the buy-sell to be paid on the death of an owner operates as a floor if the owner could sell for a higher price during the owner's lifetime. This issue may be avoided if the buy-sell agreement set the purchase price on exercise of right of first refusal for lifetime transfers as the lesser of the agreement price or the price offered by the third party buyer."

Grundmeier acknowledged Naples' observation is valid, but he stressed that appraisers must also consider there is usually time involved in offering the interest to the inside group and the outside buyer is faced with a high probability that the offer will instead be exercised by the inside group.

Grundmeier said, "there is a strong disincentive for external buyers to even make an offer unless it offers a premium to fair market value, increasing the likelihood the inside group won't exercise its right to buy it. This is a disincentive which increases the discount for lack of marketability."

MBVG Board member and Olsen Thielen Tax Principal Joe Mayer, CPA, said that the ability to sell to an outside party is not required for a buy-sell agreement to be set aside for determining values for tax purposes. "If a share-

holder can sell his interest at any price negotiated with other company employees, for example, the IRS treats this as a lifetime competitive market for the stock," Mayer said. "Often times new or key employees are allowed and even encouraged to buy stock, including the holdings of existing investors. This sets up, in the eyes of the IRS, a market for the shares."

Grundmeier noted that under circumstances, such as spelled out by Mayer, that "existing market", even though it may be small, could also reduce the discount for lack of marketability. "It really depends on the size of the pool of potential buyers and any evidence of such transactions," he said.

On January 1, 2009, the annual gift exclusion to individuals increased to \$13,000, Mayer said. That annual exclusion for gifts pertains to each donee, Mayer explained, meaning that gift tax returns do not have to be filed if the amount gifted to each donee is less than that amount, and no tax is due. The exception to this rule, Mayer said, is for future interests, which may require filing even though the value is less than the exclusion amount. From 2006 through 2008 the annual exclusion has been \$12,000; before that, from 2002 through 2005 the annual exclusion was \$11,000. These amounts are for each spouse, so that if both are contributing property, the amount is doubled.

For any gifts which are more than

the exclusion amounts, gift and generation skipping transfer taxes must be computed and filed on a calendar year basis. The taxpayer must list all reportable gifts made during the calendar year on one Form 709, according to Naples. This means, the taxpayer must file a separate return for each calendar year a reportable gift is given.

Mayer emphasized that gift tax applies not only to gifts per se, as conventionally considered, but may also be applicable to other sales or exchanges. "According to the code, when something is sold or exchanged, but the value of the property or money's worth received is less than the value of what is sold or exchanged, a gift tax may apply," Mayer said. "Such gift tax may be in addition to any other tax, such as federal income tax, paid or due on the transfer."

Gifts may be something other than tangible property. Gifts may include the exercise or release of a general power of appointment, to the forgiveness of a debt, to interest-free or below market interest rate loans, to the assignment of the benefits of an insurance policy, to certain property settlements in divorce cases, and / or to the giving up of some amount of annuity in exchange for the creation of a survivor annuity, according to Mayer.

With respect to the issues relating to estate valuation, Naples stressed that even though an agreement may require the sale of an interest at a certain price, the IRS is not required to respect the price for estate tax purposes. This could create adverse tax consequences for the estate beneficiaries, Naples stressed.



Mayer

Minnesota Business Valuation Group

Professional Business Appraisals

Minnesota Business Valuation Group, LLC

A subsidiary of

OLSEN THIELEN & CO., LTD.

Toll Free: 1 800 303 2889

Ph: 612 240 0309 Fax: 612 677 3881

Email: RSchostag@BusValGroup.Com

[Http://www.BusValGroup.com](http://www.BusValGroup.com)

BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

BUSINESS ASSET VALUATION

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

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