

Business Valuation Notes

Minnesota Business Valuation Group - 223 Little Canada Road, St. Paul, Minnesota 55117

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

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MAJOR CHANGES BY DECEMBER

PURCHASE PRICE ALLOCATION GETS UPDATE

FASB 141 Revised

The Financial Accounting Standards Board (FASB) is issuing new rules which will again revise how accountants record merger and acquisition transactions, this time affecting the way companies record target company purchase of less than 100% of another business entity and for contingencies on those purchases, such as 'earn outs'.

Although not effective until December 15, 2008, (early adoption is prohibited) appraisers, accountants, and M&A intermediaries should become familiar with the rules and be prepared, according to Randall Schostag, President, Minnesota Business Valuation Group, LLC. "The Public Company Accounting Oversight Board has already been critical of accounting auditors for failing to test purchase price allocations," Schostag said. "We think the PCAOB will be even more vigilant going forward."

The new rules were set forth December 4, 2007, in revised Statement of Financial Accounting Standard No. 141(R), *Business Combinations*, and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. The statement extends and clarifies certain issues raised but not answered by SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, issued in 2002.

As discussed in previous Business

Valuation Notes, FASB has been working closely with the International Accounting Standards Board (IASB) to converge United States and international accounting. Business combination accounting and consolidated financial reporting have been priorities of the organization. Since issuance in December, the financial press has been congratulatory, praising the 'culmination of the first major collaborative convergence project...' between FASB and IASB.



Schostag

SFAS 160: This statement requires that a noncontrolling interest in a consolidated subsidiary be displayed as a separate component of equity. Both FASB and IASB concluded that a noncontrolling interest meet the definition of equity of the consolidated entity. This important premise has driven most of the other conclusions of the new statement.

Before SFAS 160, equity interests not held by controlling shareholders have generally been referred to as minority interests. FASB changed the terminology from minority interests to noncontrolling interests of equity holders to address the possibility that a holder of a minority equity interest may control an entity and also that a holder of a majority of equity inter-

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Gift Taxes Tested

ABSORPTION DISCOUNT FOR REAL ESTATE ACCEPTED

DLOM & DLOC also Examined

The United States Tax Court has issued a Memorandum of Findings of Fact and Opinion regarding a valuation of the fair market value of certain limited partnership interests transferred for gifting purposes with Minnesota farmland holdings which contains a thoughtful discussion of valuing a large block of farm land and whether to apply a discount for absorption of such a large block, and also what to consider with respect to discounts of limited partnership interests for lack of control and lack of marketability for gifting purposes.

The decision of when, if at all, to apply a discount for absorption for a large parcel of property is an especially relevant question for the Minnesota



Bruzek

Business Valuation Group which conducts certified appraisals of real estate through its affiliation with Asset Valuations, Inc. owned by MBVG Principal Ron Bruzek. The discussion of suitable methods to use for discounts of equity ownership interests gives an ongoing understanding of the how the tax court evaluates valuations the reasonableness of such discounts for both gift and estate holdings.

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GIFTING

(continued from page 1)

The memorandum, T.C. Memo 2008-128, Docket No. 4342-06 was filed May 5, 2008.

on the matter of Jane Z. Astleford, petitioner v. Commissioner of Internal Revenue, Respondent. The decision was entered under Rule 155 and written by Judge Swift.

The court determination was required to calculate the fair market value of 1,187 acres of farmland held in a partnership (both general and limited) relating to gifts in 1996 and 1997. The petitioner / taxpayer's husband, M.G. Astleford had acquired over several years significant real estate interests, some owned jointly with taxpayer. Other properties were owned by the husband alone and still others were owned through various trusts and limited and general partnerships.

At the center of the husband's real estate business was Pine Bend Development Co., a Minnesota general partnership, with Richard T. Burger, which was formed in 1970. Pine Bend did not stipulate whether transferring general partnership interests would constitute the actual general partnership interests or if such transfers would instead be assignee interests. Eventually the court was also asked to answer that question as well.

After forming the general partnership, Pine Bend purchased 3,000 acres of land near St. Paul, Minnesota, of which the subject 1,187 acres was a part and which consisted of agricultural farmland in Rosemount, Minnesota. Pine Bend leased 944 acres of this parcel to farmers and leased out the remainder for use as a commercial paintball field. This property is located near an industrial area and oil refinery which dominates the landscape and is about six miles from a residential neighborhood. The property was not connected to municipal sewer or water.

In early 1992 the husband and taxpayer each created separate revocable trusts and they each transferred

various real estate interests to the trusts. In mid 1995 the husband passed away, and all of his real estate interests passed to a marital trust with the taxpayer the beneficiary. Thereafter, the taxpayer thus owned both her real estate interests directly and indirectly owned her deceased husband's real interests through the marital trust.

August 1, 1996, taxpayer formed the Astleford Family Limited Partnership, a Minnesota LP. Under the LP, net cashflow was to be distributed annually among the partners, although the limited partners were not entitled to vote on management issues, no outside party could become a partner without consent of taxpayer as general partner, no limited partnership interests could be sold or transferred without consent of taxpayer, and no real property interest could be partitioned without taxpayer's consent. Petitioner then transferred her interest in an assisted-living facility to the partnership and gifted each of her three children a 30% limited partnership interest (90% total), retaining the 10% interest as the general partnership interest.

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HEINZ CASE QUESTIONS

The American Institute of Certified Public Accountants (AICPA) recently summarized a tax case where the Court of Federal Claims denied a \$42.5 million refund sought by processed-food manufacturer H. J. Heinz Company for a claimed loss relating to an investment redemption. In the summary included in The Tax Advisor, January 2008, the authors noted "...strict adherence to the technical provisions of the Code may not suffice to produce tax results anticipated by a taxpayer."

Although the opinion was filed a year ago on May 24, 2007, the Minnesota Business Valuation Group believes that the case deserves review given increasing

valuation work for recapitalization / reorganization transactions, and that in most cases the recapitalizations produce tax consequences. In addition the case raises questions about economic substance which are considerations in other matters, such as family limited partnerships.

The case was filed in the United States Court of Federal Claims, No. 03-02847T by H.J. Heinz and subsidiaries as plaintiffs versus the United States. In a brief before the opinion, the refund suit was abbreviated as: "Whether a subsidiary's acquisition of its parent's stock, followed by the parent's apparent redemption of the majority of that stock, increased the tax basis in the stock retained by the subsidiary, such that capital losses were produced upon the retained stock's sale to an unrelated third party."

Giving an indication of how the ensuing opinion reads, Judge Francis M. Allegra begins by citing *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938): "A given result at the end of a straight path is not made a different result because reached by following a devious path." The Tax Advisor referred to "...Substance over form" and "...the degree of permissible tax planning surrounding a transaction." In a *tax analysts special report* in Tax Notes, October 22, 2007, author Ethan Yale focused on evaluating whether the transaction, as interpreted by the court, was really a prearranged two-step redemption transaction and thus a sham. Yale asserted that the court should be faulted for this finding.

Yale asserts that the case has several technical issues which should have been more carefully weighed by the court, and that he hopes the Federal Circuit will either consider these issues on appeal or at the least remand the case for reconsideration. He sees the Federal Circuit as bogged down with the substance versus form issue, and that the "...economic substance doctrine is notoriously imprecise..."

"Heinz presents an excellent opportunity for the Federal Circuit to clarify the content of the economic substance doctrine," Yale wrote.

FASB 141(R)

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ests might not control or consolidate an entity.

- After control is obtained, a change in ownership interest interests that does not result in a loss of control should be accounted for as an equity transaction.

- Gains or losses should not be recognized on sales of noncontrolling interests in subsidiaries. Differences between sale proceeds and the consolidated basis of outstanding noncontrolling interests should be accounted for as charges or credits to consolidated paid-in capital. This also changes the original SFAS 141 wherein step acquisitions was the practice, now changed in 141(R).

- A change in ownership that results in a loss of control and deconsolidation is a significant event that triggers gain or loss recognition, with the establishment of a new fair value basis in any remaining ownership interests.

Prior to the new rule, accountants have commonly reported minority interests as a kind of 'mezzanine' entry between balance sheet liabilities and shareholders' equity. By dropping this vague notion of neither debt nor equity and instead treating the noncontrolling interest as equity, FASB is adopting an 'economic entity' concept whereby it recognizes that all residual economic interest holders in equity have an equity interest, even if the residual interest is relative to only a portion of the equity.

Acknowledging that there are differences between controlling and noncontrolling interests, SFAS 160 requires them to be presented as separate components of equity in the statement of financial position along with comprehensive disclosures about attributes and transactions pertaining to noncontrolling interests in the footnotes. Earnings will now be reported as part of consolidated earnings, although the accountant must also disclose attribution to the controlling and noncontrolling interests in the footnotes.

Schostag said that allocation of earnings for some of the existing minority interests may be problematic in that

in some cases there is a contractual arrangement for an earnings split which may differ from earnings based simply on a per share distribution. In those instances appraisers may also be uncertain how to ascertain the number of shares to be used for a per share equity value.

"It appears as though whatever the earnings split was before December 15, 2008, the effective date to implement the new standard will also hold true for those securities' attributes afterwards," Schostag said. "Therefore, whatever provision the appraiser made with regard to the number of shares and earnings will remain the same in the analysis."

Consideration of a noncontrolling interest and a controlling interest with respect to book value, however, will be more difficult when using an asset-based approach to value, viz., the net book value. Among other factors, the basis for the controlling interest will be adjusted, for example, for any step up, such as for goodwill in an acquisition.

Before the new standard effective date, that asset would not be stepped up in the target company, so that there is a difference in amounts recorded by the target company and the new controlling interest holder. "If there is a subsequent charge for goodwill in this instance," Schostag said, "that charge would only be levied against the net income and assets of the controlling shareholders' interest, but not within the target company."

After the standard effective date, Schostag said, there will be an adjustment in the remaining noncontrolling interests which will then include an allocation of adjusted fair values, income, and expenses associated with the entity, based on the acquirer's carried values and prorated according to ownership.

SFAS 160, as amendment to ARB 51, carries forward, without reconsideration, the elimination of intercompany investments, the elimination of intercompany income or loss, income taxes paid on intercompany transfer profits, stock dividends of subsidiaries, combined financial statements, and parent-company financial statements.

SFAS 160 has also not effected FASB No. 46(R), *Consolidation of Vari-*

able Interest Equities, which provides guidance about determining whether control has been obtained or lost. However, FASB has now defined a noncontrolling interest as: "The portion of equity (residual interest) in a subsidiary attributable to the owners of the subsidiary other than the parent and the parent's affiliates." FASB also concluded that only financial instruments qualifying for equity classification may be considered noncontrolling interests.

SFAS 141(R): Along with standard 160, FASB has made several revisions for accounting for *Business Combinations*, issuing standard 141(R), also issuing those changes in late 2007 to become effective in late 2008.

In *Business Valuation Notes*, Volume 1, Issue 2, August 2001, MBVG first discussed how FASB had issued Standard 141 and Standard 142 (relating to Goodwill and Other Intangible Assets). The new standards had been in development since August 1996; FASB's first exposure draft was issued in 1999 and it adopted the new standard in a unanimous vote June 29, 2001 and was made available on July 20, 2001.

MBVG was among the few early valuation firms of its size to understand that these standards heralded a change by FASB away from historical accounting and toward present value accounting. Schostag said that after several years of contentious debate within the accounting community, the issuance of these two standards in 2001 showed that those who favored present value accounting and integration into the world accounting community had won. Those who wanted the status quo and historical accounting had lost.

"The issuance of the new standards 141 and 142 was a sea change in accounting," Schostag said. "It was largely because of how we viewed these changes that the Minnesota Business Valuation Group changed its business model, acknowledging the growing importance of valuation to the practice of accounting, and enhancing its practice to offer the necessary skills required. Up to that point, our focus had been gift and estate tax valuation and work on employee stock ownership plans."

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FASB 141(R)

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Although MBVG has continued its expertise in gift / estate and ESOP valuations, the subsequent promulgation of accounting standards which require more attention to valuation expertise underscores the sea change within the accounting profession since 2001, according to Schostag. "The American Institute of Certified Public Accountants has become the single most important standard setter in valuation, where it previously played an insignificant role. Valuation firms which are not associated with public accounting firms are now on the outside looking in," he said.

Seven years following its issuance, among other modifications to SFAS 141, the new revisions include requirements to:

- Recognize, with certain exceptions, 100% of the fair values of assets acquired, liabilities assumed, and noncontrolling interests in acquisitions of less than 100% controlling interest when the acquisition represents a change in control of the acquired entity. Before this change, where there has been less than a 100% acquisition, there has been a mixture of values, i.e. historical carrying values for the residual noncontrolling interest and fair value for the controlling interest. The revised reporting will now reflect the belief that the new controlling interest acquirer is now responsible for the target as a whole.

- Measure acquirer shares issued in consideration for a business combination at fair value on the acquisition date.

- Recognize contingent consideration at their acquisition date fair values, with subsequent changes in fair value generally reflected in earnings. This is a big change from SFAS 141 which recorded contingent considera-

tion obligations when the contingencies are resolved, and the consideration is issued or becomes issuable. This also includes contingent consideration which may be returned (contingently returnable) if specific future events fail to occur. Subsequent changes in consideration, where events result in a difference in these contingent obligations, do not produce a change in the purchase price as of the date of the transaction, but rather are adjusted through the income statement.

- With certain exceptions, recognize preacquisition loss and gain contingencies at their acquisition date fair values. Generally, there will be no recognition for non-contractual contingencies which are not determined to be more likely than not of materializing; subsequent recognition should be probable and reasonably estimable.

- Capitalize in-process research and development assets acquired. Previously R&D with no alternative future use were measured at fair value and then expensed. Under the revised statement, these intangible assets will now be recognized as assets. Of course, R&D expenses after the acquisition date will continue to be expensed unless they meet the test of alternative future use as before.

- Expense, as incurred, acquisition-related transaction costs. FASB here reasons that these costs are not part of the fair value of the exchange so that both direct and indirect costs are expensed. Indirect in this instance includes the target's costs. However, this rule does not extend to financing costs incurred.

- Capitalize acquisition-related restructuring costs only if certain criteria are met (see SFAS 146). This will limit the accrual of restructuring costs in a purchase price allocation to restructuring obligations incurred as of the acquisition date. If costs associated with restructuring or exit activities do not meet criteria of SFAS 146 as of the acquisition date, then they will be generally considered post-combination expenses.

- Recognize changes that result from a business combination transaction in an acquirer's existing income tax valuation allowances and tax uncertainty accruals as adjustments to income tax expense.

GIFTING

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In December 1997 taxpayer transferred her 50% Pine Bend interest and 14 other real estate properties located in the Twin Cities metropolitan area to the partnership. This transfer / capital contribution significantly increased taxpayer's prorate ownership in the partnership. This increase in the relative partnership contributions was then offset with taxpayer gifting each of the three children additional limited partnership interests, thus again bringing taxpayer's comparative level of ownership back down to about 10%. The children's ownership was always derived by the gifting and was not obtained through any other individual contribution to the partnership.

When the Internal Revenue Service (IRS) audited the gifts, it increased the fair market values of some of the properties which were transferred by taxpayer into the partnership, thus increasing the partnership's aggregate net asset value. The IRS also decreased the discounts for lack of control and lack of marketability which taxpayer had applied. The IRS adjustments increased taxpayer's gift tax liability from taxpayer's estimates of \$79,581 in 1996 and \$2,005,689 in 1997 to \$127,619 and \$3,997,288, respectively, according to the court's memo.

The tax court's responsibility was to evaluate the differences in tax liability of the tax payer compared to the IRS. The taxpayer and IRS disputed only the value of the Rosemount farm land and also the discounts used for lack of control and marketability for the gifted interests.

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GIFTING

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Rosemount Farm Land: The difference in gifting tax conclusions started with a difference in per acre value, the taxpayer's expert using \$3,100 per acre, based on 18 comparable farm properties that had been sold. The IRS's expert reviewed about 125 Minnesota farmland properties and apparently personally visited 12 of the properties to assess comparability. The IRS expert narrowed those properties to two comparables, based on date of sale, and used a per acre value of \$3,500.

The court favored the IRS expert's screening process to obtain comparables and used the IRS \$3,500 per acre value. Based on 1,187.51 acres, this increased the initial calculated value of the real estate from taxpayer's \$3,681,000 to \$4,156,000.

Bruzek said that the \$400 per acre difference between the findings of the IRS and taxpayer's expert was less than 13% and an amount on which reasonable people may disagree. More important, he said, was the court's application of a discount for absorption of the large holdings based on the size of the block of land. Bruzek noted the court's reference to the average farm size in Minnesota (160 acres) compared to the 1,187-acre site owned by Pine Bend, and agreed that this much larger size warranted an adjustment from the initial value, called absorption.

"Selling such a large tract within the community is like selling a large block of common stock in a market with a much smaller average trading volume," Bruzek said. "In the real world, selling such a large parcel over a short period of time will almost certainly reduce the price."

Although the IRS expert argued that because 3,000 acres of land (including the Rosemount property) had been purchased by Pine Bend in 1970 in a single transaction and thus could be sold without a discount, the tax court disagreed and permitted an absorption discount. However, the tax payer used an absorption discount rate of 25%,

based on statistics for real estate developers.

The tax court considered the discount rate too high, explaining that real estate developer projects expect greater returns and greater risks. Since the subject land was primarily for farming and that was also the expected future use, the court believed that the risk of continuing to receive that return was minimal and related to what other farmers in the area were actually earning, i.e., 9.2%. Therefore, in place of a 25% absorption rate discount, the court substituted a 10% rate.

By changing the absorption rate discount from 25% to 10% and applying it to the higher per acre value before discount, the per acre value increased to \$2,786.14, up from the taxpayer's use of \$1,817 per acre, but below the IRS expert's use of \$3,500, which did not include any absorption discount. The total value of the 1,187.51 acres after absorption was thus determined by the tax court to be \$3,308,575 compared to \$2,160,000 by the taxpayer and \$4,156,000 by the IRS.

Discounts for Lack of Control & Marketability of partnership interests: For the DLOC and DLOM calculations used, the taxpayer relied on comparability of data from sales of registered real estate limited partnerships (RELPs) while the IRS expert relied on comparability data from the sales of publicly traded real estate investment trusts (REITs).

The tax court accepted both methods (RELP and REIT), noting that the RELPs more closely resembled the subject partnership, but that there were more REIT transactions, thus minimizing the potential problem of differences.

"The tax court offers an excellent discussion about the experts' use of the empirical information, including excluding post effective date transactions," according to MBVG President Randall Schostag. "The court differentiated the companies in the databases, citing a much higher financial leverage (debt) used by the comparables and greater average cash distribution of the partnership, thus implying lower risk for the gifted interests." The tax court con-

cluded that the taxpayer expert's comparable were too different, did not deserve the reliance used, and that the taxpayer's DLOC was therefore excessive.

The court instead used the REIT data and explained its use for assessing a liquidity premium (the opposite of a DLOM) and a DLOC. The tax court believed that the IRS expert was correct to eliminate the effect of a liquidity premium from the REIT data to determine a discount for lack of control; however, the court said that on its face the discount the IRS used was too low and conflicted with other liquidity premium information used by that expert within the same report. Therefore, the court incorporated the other liquidity premium / discount for lack of marketability data, and using the other modeling of the IRS expert determined an adjusted DLOC which it then applied.

"The tax court has considerable latitude in ascertaining value," Schostag said. "It will examine evidence and opinion of expert witnesses, but it is permitted to choose one expert's opinion over another and may be selective about what part of an opinion it accepts."

Assigned interest or general partnership interest: The tax court also had to determine if the interest transferred by gift was a general partnership interest or merely an assignee interest.

The court chose "substance over form" in this matter, electing to treat the gift as the transfer of a general partnership interest rather than as an assigned interest.

"When you are discussing conveyance issues with your lawyer, you will likely often hear him or her describe certain limitations which a particular estate planning transaction may use," Schostag said. "The attorney may emphasize that the words used are not merely there for window dressing, such as when control aspects are set forth. That is because the courts are concerned about the actual intent of the parties, rather than what has been written on a paper."

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

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