

Business Valuation Update

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Business Valuation Update

- Court case update
 - Estate of Strangi I
 - Estate of Strangi II
 - Estate of Kimbell v. U.S.
 - Estate of Thomas v. Commissioner
- Failed IPO Study
- IRS Marketability Discount Approaches
- Professional v. Enterprise Goodwill

Estate of Strangi I

IRC 2036: The value of the gross estate includes the value of all property to the extent of any interest therein which the decedent has at any time made a transfer, except by bona fide sale for adequate and full consideration, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not end before his death:

Estate of Strangi I

- a) Possession or enjoyment of, or the right to the income from, the property, or
- b) The right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income there from.

Estate of Strangi I

- A transferor retains “Possession or enjoyment” if he retains a “substantial present economic benefit” from the property, as opposed to a “speculative contingent benefit which may or may not be realized.”

Estate of Strangi I

1. Strangi forms a FLP (SFLP)
2. Transfers assets
 - Securities
 - Real estate
 - Insurance policies
 - Annuities
 - Partnership interests
3. In return, he receives a 99% limited partnership interest

Estate of Strangi I

4. The FMV of the property was about \$10 million
5. 75% of the property was cash and securities
6. Stranco, Inc. is formed by Strangi's children
7. Stranco contributes about \$100,000 to SFLP in exchange for a 1% general partnership interest

Estate of Strangi I

8. Strangi dies in October 1994.
9. SFLP made cash outlays in money and in-kind to meet Strangi's needs and expenses
 - \$14,000 in September and October
 - \$40,000 for funeral expenses and estate administration
 - All payments included pro rata payments to Stranco

Estate of Strangi I

10. Prior to death, Strangi lived in one of two houses transferred to SFLP
11. The estate tax return reported SFLP as an ongoing business and applied discounts totaling 33% in valuing Strangi's interest

Estate of Strangi I

12. IRS issues a deficiency
 - Under the business purpose and economic substance doctrines, SFLP should be disregarded in valuing the assets
 - Later argument: IRS argued that Code Section 2036(a) applied and that the transferred assets should be included in the estate

Estate of Strangi I

- Tax Court held in favor of SFLP
 - FLP was valid under state law and would be recognized for estate purposes
 - The transfer of assets to the FLP in its formation did not result in taxable gifts by Mr. Strangi to the other partners

Estate of Strangi I

- Tax Court held in favor of SFLP
 - The FLP agreement itself did not constitute a restriction under Code Section 2703
 - Strangi's interest in the FLP should be valued on a discounted basis

Estate of Strangi I

- During the trial, the IRS was barred from arguing Code Section 2036 because they were late to raise the issue.

Estate of Strangi I

- On appeal, the Fifth Circuit partially affirmed and partially reversed the tax court
 - It held that the FLP:
 - Was valid under state law
 - Disregarded for transfer tax
 - It reversed the Tax Court's denial of the IRS motion to amend the petition to include Code Section 2036 arguments
 - The case was remanded to the trial court

Estate of Strangi II

- The tax court found in favor of the IRS including SFLP assets in the estate
 - 99% of the net asset value
 - 47% of the assets held by Stranco
- Strangi retained an interest in the assets transferred to the SFLP and Stranco

Estate of Strangi II

- The court found:
 - No bona fide sale existed in terms of an arm's length transaction
 - Full and adequate consideration does not exist where there has merely been a recycling of value through partnership or corporate solution

Estate of Strangi II

- The court found:
 - The SFLP / Stranco arrangement patently failed to qualify as the sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling

Estate's Fifth Circuit Court Appeal

- First Argument:
 - The Tax Court erred in holding that Strangi retained possession or enjoyment of the property he transferred to SFLP or the right to designate who would enjoy it. Without this interest or right, Code Section 2036 does not apply.

Estate's Fifth Circuit Court Appeal

- Second Argument:
 - Even if he retained possession or enjoyment, the transfer did not fall within the Bona fide sale exception to Code Section 2036

Estate's Fifth Circuit Court Appeal

- First Argument Findings:
 - The benefits retained by Strangi
 - Payments before and after death
 - Continued use of the house
 - Post death payments of expenses
 - Were "Substantial" and "present" not "speculative" or "contingent"

Estate's Fifth Circuit Court Appeal

- First Argument Findings:
 - Part of the possession or enjoyment is the assurance that the assets will be available to pay various debts and expenses upon one's death
 - Strangi had very little other liquid assets to use for support, so an arrangement must have been made with SFLP

Estate's Fifth Circuit Court Appeal

- First Argument Findings:
 - Strangi retained assets barely sufficient to meet his own living expenses for the low end of his life expectancy

Estate's Fifth Circuit Court Appeal

- Second Argument Findings:
 - SFLP met the requirement of "Adequate and full consideration"
 - To be a bona fide sale, it must serve a substantial business or other non-tax purpose

Estate's Fifth Circuit Court Appeal

- Second Argument Findings:
 - Estate raised several arguments that were all rejected
 - Deterring potential tort litigation from a former housekeeper
 - Deterring potential will contest by children of Strangi's second marriage
 - Persuading a corporate executor to decline to serve
 - Create a joint investment vehicle for partners
 - Permitting centralized management of working interests owned by Strangi
 - SFLP did not meet the bona fide sale exception

Estate of Kimbell v. U.S.

- Kimbell v. U.S., 2003-1 USTC
 1. Ruth Kimbell forms FLLC in January 1998.
 2. She was 96 years old
 3. Kimbell's trust contributed \$20,000
 4. Son and his wife each contribute \$10,000

Estate of Kimbell v. U.S.

5. Later in January 1998, Kimbell's trust and the new FLLC form a limited partnership RA Kimbell Property Co, Ltd. (FLP)
6. Trust contributes \$2.5 million for a 99% limited partnership interest
7. FLLC contributes \$25,000 in cash for a 1% general partnership interest

Estate of Kimbell v. U.S.

8. Kimbell dies in March 1998
9. Estate claims a combined 49% discount from the net asset value of FLLC and FLP
10. Upon audit, the IRS argues the assets should be included in the estate pursuant to IRC 2036

Estate of Kimbell v. U.S.

11. District Court initially ruled in favor of the IRS
12. Estate appeals to Fifth circuit which vacated the case and sent back for remand

Estate of Kimbell v. U.S.

- The primary issue was the bona fide sale
- Kimbell retained more than \$450,000 of her assets outside of the partnership for her own support, and there was no commingling of personal assets
- All significant partnership formalities were properly followed

Estate of Kimbell v. U.S.

- One of the assets transferred included oil and gas properties which require active management
- Credible evidence of non tax reasons for the formation of the partnership were provided
- Final decision was that discounted value of the FLLC and FLP should be included in the estate

Estate of Thompson v. Commissioner

- Estate of Thompson v. Commissioner, TC Memo 2002-246
 1. Thompson transferred \$2.8 million of assets to two FLP's
 2. Transferred assets were nearly 95% of his assets

Estate of Thompson v. Commissioner

3. Thompson received 95.4% of one FLP and 62.27% of the other FLP
4. Thompson retained only \$153,000 for his own disposal
5. He received \$14,000 from social security ad annuities
6. At the time of transfer his expenses were \$57,000 per year
7. His actuarial life expectancy was 4.1 years

Estate of Thompson v. Commissioner

- The court found that Thompson only had assets to support himself for 3.54 years
- Thompson would likely need funds that could only come from the partnership

Estate of Thompson v. Commissioner

- The court inferred that he had retained a practical right to the assets transferred
 - The decedent did need consent of the other partners to receive distributions
 - Children readily admitted that they would not have denied their fathers request

Estate of Thompson v. Commissioner

- The court also determined that the transfer did not meet the bona fide sale exception of IRC 2036
 - No adequate consideration
 - Lacked business purpose

Strategies

- Do not commingle personal and partnership assets
- Do not transfer 100% of personal wealth to an FLP
- Retain adequate assets to meet expected lifestyle needs

Strategies

- Ensure that distributions are based on ownership percentages
- Be willing to give up some control as general partner
- Make sure that the FLP has more than one valid and compelling non tax business purpose

Strategies

- Have each family member contribute adequate assets in exchange for their partnership interest
- Establish the FLP when partners are healthy
- Follow the requirements of the partnership agreement

Failed IPO Study

- Marketability is the ability to convert property to cash at a minimal cost
- Discount for Lack of Marketability is an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability

Failed IPO Study

- A DLOM can apply if either a controlling or minority position
- Generally, a controlling interest will have a lower DLOM than a minority position

Failed IPO Study

- A controlling position faces the following considerations supporting the need for a DLOM:
 - Uncertain time horizon to complete the offering or sale
 - Cost to prepare for and execute the offering or sale
 - Risk concerning eventual sale price
 - Non cash and deferred transaction proceeds
 - Inability to hypothecate the shares

Failed IPO Study

- IRS (and others) has argued that applying a DLOM for a controlling position is inappropriate based on the hypothesis that a controlling owner can cause the company to pursue an IPO

Failed IPO Study

- Willamette Management Associates completed the “Failed IPO Study”
- Comparison of the number of failure of IPO’s to the number of successful ones
- Data was for 1990 through 2002

Failed IPO Study

- Key data:
 - 1. Number of IPO SEC registrations
 - 2. Number of completed IPO’s
 - 3. IPO failure rates
 - 4. Elapsed time from the IPO registration date until the date of the successful IPO

Failed IPO Study

- About 8,100 companies filed an IPO registration
- About 1,800 companies did not complete their IPO
- The actual failure rate was 23.3%

Failed IPO Study

- The failure rate range by year was 10% for 1991 and 54% for 2000
- The average time to successfully complete an IPO was three months
- The investment banking fees for a successful completion was 7.5% of the initial market capitalization (plus additional professional fees and costs)

Failed IPO Study

- Controlling interest positions experience the following elements of illiquidity
 - An uncertain stock price
 - A significant transaction cost
 - A significant time for the sale

IRS Marketability Discount Approaches

- Based on *Gross, McCord, Lappo and Heck*
 - Analysis based on 88 private placements
 - 51 Restricted stocks
 - 37 Registered shares
 - Both placements took place at a discount to the publicly traded price

IRS Marketability Discount Approaches

- Concluded since the registered shares are liquid but still sell at a discount, the registered share discount represents something other than a DLOM

IRS Marketability Discount Approaches

- IRS expert surmised the registered share discount was to recompense the investor for:
 - Assessing the investment
 - Monitoring the investment
 - Providing advice to management
 - A promise of future investment

IRS Marketability Discount Approaches

- IRS expert further concluded that private placements of restricted stock must also represent in addition to a DLOM:
 - Return to the investor for assessment
 - Monitoring the investment
 - Providing advice to management
 - A promise of future investment

IRS Marketability Discount Approaches

- Therefore, the IRS expert concluded that the DLOM could not exceed the discount for restricted stock minus the discount for registered shares

IRS Marketability Discount Approaches

- Flaws in IRS expert's assumptions
 1. The registered stock in the was not liquid, it was illiquid
 2. The DLOM is the same for all types of companies notwithstanding the significant differences in financial and operating performance
 3. The comments on assessment, monitoring, advice and future investment must hold true

Professional v. Enterprise Goodwill

- Fast becoming a "Hot topic" in Ohio divorce cases
- Goodwill attributed to the professional is typically not an asset subject to division

Professional v. Enterprise Goodwill

- Professional goodwill, or sometimes personal goodwill is the goodwill that is created by and directly attributed to the name, reputation and abilities of the individual providing the service
 - This is a function of the amount of business that will no longer be referred or will not repeat without the seller

Professional v. Enterprise Goodwill

- Enterprise goodwill is the goodwill that is attributed to name, reputation, customer loyalty, location, products relating to the company or enterprise
 - This is a function of the amount of business that will continue to be referred or will repeat without the seller

Professional v. Enterprise Goodwill

- It is likely that the two elements of goodwill can co-exist
- Goodwill is a component of a functioning business
 - Therefore, a going concern is assumed
 - Excepting identifiable intangible assets, goodwill will evaporate to close to zero if the business liquidates

Professional v. Enterprise Goodwill

- The consequences of a Non-Compete Agreement
 - Many arguments for goodwill being classified as professional goodwill is the requirement for a non-compete agreement
 - Further arguments are that the value of professional goodwill is equal to the value of the non-compete agreement

Professional v. Enterprise Goodwill

- A non-compete agreement is an essential element of any business sale, irrespective of the nature of the goodwill
- Creates protection for the buyer to eliminate immediate competition from a worthy competitor
- If fair market value assumes a hypothetical sale, then fair market value also assumes a hypothetical non-compete agreement

Professional v. Enterprise Goodwill

- Consider the following:
 - Total Goodwill (TG) potentially consists of both Professional Goodwill (PG) and Enterprise Goodwill (EG), therefore:

$$TG = PG + EG$$

Professional v. Enterprise Goodwill

- Fair market value consists of tangible assets (TA) and total goodwill (TG)
 - Remember FMV includes a non-compete agreement (nca)

So we know:

$$\text{FMV w/nca} = \text{TA} + \text{PG} + \text{EG}$$

Professional v. Enterprise Goodwill

- For a non-compete agreement to equal the value of professional goodwill, the following equation must be true:

$$\text{FMV w/nca} - \text{FMV wo/nca} = \text{nca} = \text{PG}$$

So then, this must also hold true:

$$\text{FMV wo/nca} = \text{TA} + \text{EG}$$

Professional v. Enterprise Goodwill

- If entity goodwill is affected by the non-compete agreement, then the preceding formula is false
- If the formula is false, then the value of the non-compete agreement cannot equal professional goodwill

Professional v. Enterprise Goodwill

- For a buyer to ensure that a seller will not interfere with the sale, the buyer will require a non-compete
- For a seller to maximize the selling price, they will agree to a non-compete agreement

Professional v. Enterprise Goodwill

- The essence of goodwill is the repeat business
 - Can be either existing customers
 - Or new customers based on reputation
- Absent a non-compete agreement, none of the goodwill is assured to transfer irrespective of the nature of the goodwill

Professional v. Enterprise Goodwill

- If any portion of the enterprise goodwill is transferable to the buyer as a result of the non-compete agreement, the value of the non-compete agreement cannot be solely equated to professional goodwill

Professional v. Enterprise Goodwill

- Without a non-compete agreement, professional goodwill is virtually eliminated and entity goodwill is reduced
- If the non-compete agreement is not equal to professional goodwill, then what does it represent?
 - The non-compete agreement is restriction on competition

Professional v. Enterprise Goodwill

- The higher amount of personal service rendered, the higher amount of professional goodwill
- The higher amount of enterprise service, the higher amount of enterprise goodwill

Business Valuation Update

Thank you for attending...

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