Viewpoint on Value

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John M. Leask II CPA, LLC.

Business Valuation Services

John M. Leask, II
(Mac)
CPA/ABV, CVA

765 Post Road, Fairfield, Connecticut 06824
Phone: 203-255-3805 • Fax: 203-380-1289
E-mail: Mac@LeaskBV.Com • Web Page: www.LeaskBV.com

When selling isn't an option

Alternative strategies to recoup your investment

For most entrepreneurs, their largest asset is their closely held business interest. While private stock can be valuable, it's also relatively illiquid. Salaries, distributions and shareholder loans provide some cash flow to owners. To tap into the bulk of the business's value — either at retirement or to move on to other ventures — some owners expect to sell their company.

Unfortunately, in today's business climate, owners can't rely on getting top dollar for their investment. Until the market improves, business owners might consider alternative exit strategies, such as:

Joint ventures

Owners nearing retirement often possess an attractive trait — experience running an established company. Such experience may help entice competitors, suppliers, customers or other investors to team up in a joint venture. In this scenario, the owner of the established business assumes a consulting role and then gradually transfers management to its strategic partner.

Some retiring owners eventually sell their interests. Others retain their interest in the combined entity but become silent partners or board members.

Careful selection of a strategic partner promotes business continuity and maximizes return. A strategic buyer might be willing to pay a premium over fair market value if the business interest contributes value-added synergies. In addition, a joint venture gives both parties the opportunity to test the waters before committing to a long-term arrangement.

Management buyouts

Before soliciting outside investors, business owners should look at existing managers and co-owners. These are potential buyers who already know how the business runs, thus easing the transition to new ownership and minimizing the hassle of due diligence performed by an outside party.

Some management buyouts are financed via an employee stock option (ESO) program, which in some companies supplements management compensation packages. Other buyouts occur through buy-sell agreements, where other shareholders buy out a departing owner's interest. (For more on buy-sell agreements, see "Back to the future" on page 3.)

ESOPs

An employee stock ownership plan (ESOP) is a form of defined-contribution retirement plan in which employees become owners over time. To qualify for favorable tax treatment, ESOPs cannot discriminate in favor of highly compensated employees or owners. Most ESOPs allow all full-time employees with at least one year of service to participate.

How does an ESOP work? The firm sets up an employee benefit trust, which it funds with company stock or with cash to buy the stock. Sometimes the trust borrows money to buy it. The trust can purchase stock from shareholders, thereby creating

a market for their shares and thus providing them liquidity. Because qualifying contributions are a tax-deductible expense for the company, ESOPs offer numerous tax advantages. But they're complex and highly regulated.

Family succession planning

If family members are qualified and willing to assume ownership of the business, this is an option. But good succession and estate planning is critical. This year, owners can transfer more of their business gift-tax-free because the lifetime gift tax exemption is $5.12 million — but it's scheduled to drop to $1 million in 2013.

Estate planning vehicles — such as grantor retained annuity trusts (GRATs) and family limited partnerships (FLPs) — can enable owners to gift business interests at substantial discounts from the net asset values of the entity's underlying assets. These discounts arise because recipients lack control over decision-making, as well as a ready market for selling their gifted interests. The size of lack of control and marketability discounts varies depending on factors such as transfer restrictions, trust or partnership agreements, the nature of the underlying assets and state law.

Expert insight

Business owners don't have to sell for less than a fair price or hold on until the market improves. There are other creative exit options worth considering. A valuation professional can help you find the optimal strategy that allows you to fund the next stage of your life. ●

Owner's motto: Be prepared

Not all business exits are planned. Owners may die, shareholders may part ways or financial failure may necessitate liquidation. Operating in a sale-ready state will help maximize returns when the unexpected strikes.

But what does "sale-ready" mean? It refers to clean, transparent business operations with assets in good working condition and minimal reliance on key people. Put yourself in a potential buyer's shoes and evaluate what could make your business a more attractive acquisition candidate.

For example, pricing multiples often are a function of earnings. So, you might need to carve out tangential business ventures or stop flushing personal expenses through business accounts. The fewer normalizing adjustments your earnings require, the higher the selling price. Minority shareholders also can complicate a sale, so you might consider buying them out.

Back to the future

Create a viable buy-sell agreement now

It would be wonderful if the future just took care of itself. But in the case of buy-sell agreements, the future depends on what's done today. For businesses, an unforeseen event such as the death of an owner can quickly turn into a crisis that could lead to a transfer of ownership.

Businesses with more than one owner, therefore, need a buy-sell agreement to provide both liquidity and an orderly ownership transition in the face of an owner departure — whether unexpected or planned. But it's not enough to have a buy-sell agreement in place. Its provisions related to the business's value and the pricing of shares also must be properly thought out.

Valuation can solve problems

There's a good reason owners turn to professional appraisers to value their businesses for buy-sell agreements. Shareholders must agree on a valuation firm's qualifications and independence, so the resulting valuation under the agreement is likely to be objective. Independent valuation can also help owners avoid legal battles and ensure values stand up well under legal challenge.

Valuation is at the heart of most disputes the IRS has with an estate that contains a substantial closely held business interest.

There's no single, surefire method of determining an appropriate share price in buy-sell agreements — nor is the price necessarily the same in all situations. Owners can set a price in a number of ways. Most buy-sell agreements specify one or a combination of the following approaches:

- A predetermined formula that refers to book value, capitalized earnings or other readily identifiable measures,
- Mutual agreement as to the shareholders' judgment of value, or
- Independent appraisal.

Formula approaches imply that some "black box" exists from which to derive a credible value. But a formula approach is unlikely to enable the buy-sell agreement to both facilitate estate planning and provide liquidity at a fair market value during the owners' lifetimes.

Similarly, mutual agreement may not be the best price-setting mechanism because owners can be blind to their own self-interests. They tend to think that their co-owners will leave the company first. Thus, they may agree to a "conservative" buy-sell value with the hope of exercising a purchase option (or obligation) at a favorable price. But of course such a price may understate the value of the shares.

Pass the IRS and court tests

The IRS scrutinizes buy-sell valuations, especially those involving family businesses, leading to disputes that often end up in court. Valuation is at the heart of most disputes the IRS has with an estate that contains a substantial closely held business interest. If the IRS determines that fair market value is higher than the amount calculated under a buy-sell agreement, the estate could owe tax on an amount it never received, leaving heirs much less than anticipated.

Under Chapter 14 and Internal Revenue Code Section 2703, which addresses the buy-sell agreement in a family setting, the *IRS* generally will accept the value prescribed by a buy-sell agreement only if:

1. It's a bona fide business arrangement,
2. It's not simply a device to transfer stock to family members for less than full and adequate consideration, and

3. Its terms are similar to arrangements entered into by persons in an arm's-length transaction.

Courts tend to rule that buy-sell agreements establish value for estate tax purposes if:

- The value appears fair and adequate when the parties agree,
- The agreement has a well-defined price-setting mechanism, and
- The agreement obligates an estate to sell.

Courts also are more likely to uphold a value if the agreement effectively limits lifetime sales at more than the agreed price — usually through rights of first refusal granted to co-owners or the company itself.

Secure the future — act now

Failing to clearly define how value is to be determined, and how often, can lead to disputes that may undo the benefit of having a buy-sell agreement. A poorly thought-out one can cause more problems than it solves — for example, owners may overlook or ignore the agreement, leading to disputes. Fortunately, most of these problems can be avoided by employing experienced advisors to address share price and funding issues. ●

Uncommon events that could trigger a buy-sell agreement

Most people are familiar with having a shareholder's death or voluntary departure trigger a buy-sell agreement. But they often fail to consider other events that can affect the future of the business, such as when:

- An owner or shareholder becomes disabled,
- Married owners or shareholders divorce,
- A minority owner is fired, or
- An owner faces personal bankruptcy.

Another triggering event can be conviction for committing a crime or involvement in a scandal. Buy-sell agreements are often structured to force an owner guilty of such an indiscretion to sell at a lower price.

Will your FLP be DOA?

Estate of Liljestrand provides some clues

The recent U.S. Tax Court case *Estate of Liljestrand* reads as a case study of what *not* to do with a family limited partnership (FLP). Because of numerous FLP missteps, the court ruled that assets transferred to the FLP were includible in the deceased's taxable estate. This resulted in a tax deficiency of approximately $2.6 million.

Case history

From 1984 through 1997, a retired doctor owned 14 real estate investments through a revocable trust. The doctor's son, Robert, managed these properties.

The doctor wanted to leave his properties equally to his four children, but he wanted Robert to continue

managing the portfolio. So he created an FLP in 1997. The trust transferred the entire real estate portfolio, worth approximately $5.9 million, to the FLP in exchange for a 99.98% interest in the FLP. Robert was granted one limited-partner unit.

In 1998 and 1999, the doctor gifted limited-partner units to his children. Each gift exceeded the annual gift tax exclusion, but no tax returns were filed until after the doctor died in May 2004. How the estate valued partner units is unclear. A valuation firm provided a formal appraisal, but the estate ignored it when filing its gift and estate tax returns.

IRS issues

The IRS argued that, despite the trust's transfer of the real estate's legal title to the FLP, there was no discernible difference in how the parties treated the real estate before and after the transfers. The FLP didn't hold regular meetings or maintain proper books and records. In addition, the FLP didn't have a separate bank account until its third year in existence.

The doctor's personal assets were commingled with FLP assets. In fact, he claimed FLP income on his personal tax returns through 1999, when his accountant discovered the FLP existed. No amended tax returns were filed for 1997 or 1998, however.

Moreover, the doctor contributed virtually all of his income-producing assets to the FLP, and he received a disproportionate share of FLP distributions. The FLP directly paid personal expenses for the doctor and his family members — including the doctor's estate tax obligation — without promissory notes or evidence of repayment.

Court weighs in

The court criticized the FLP's after-the-fact journal entries as an attempt to rectify inadequate accounting records and disproportionate distributions. Initially, the FLP's accountant reported disproportionate distributions and personal expense payouts as draws against the partners' capital accounts. After the doctor's death, these journal entries were reversed and booked as partnership receivables. Yet no promissory notes were executed and no repayments made.

> The court ruled that the assets transferred to the FLP weren't part of a bona fide sale for full and adequate consideration.

The court ruled that these "accounting manipulations" didn't "refute the implied understanding that Dr. Liljestrand could continue to use and control the partnership property during his life." It also ruled that the assets transferred to the FLP weren't part of a bona fide sale for full and adequate consideration. The FLP used neither the formal appraisal's value conclusions nor the real estate's fair market value to establish gift or estate value.

As a result, the court concluded that the deceased retained enjoyment of the assets transferred to the FLP in accordance with Internal Revenue Code

Section 2036(a). Therefore, the assets' fair market value was includible in his gross estate.

Lesson learned

Liljestrand highlights several important lessons. First, attention to FLP formalities and retaining sufficient personal assets outside the FLP are keys to surviving IRS scrutiny. In addition, timely communications between FLP interest holders, legal counsel and financial advisors are likely to help prevent missteps in FLP administration.

This case also shows that postmortem journal entries won't persuade the court to overlook suspicious FLP payouts. The Tax Court is interested in substance over form.

Finally, the court didn't look favorably on the noticeable contradiction between the estate's do-it-yourself values and the formal outside appraisal. A formal business appraisal is essential to helping ensure an FLP withstands IRS and Tax Court scrutiny. ●

The critical difference between valuations and calculations

Some business owners shortcut a comprehensive valuation with a calculation to save time and money. But at what expense?

Valuations, which require a full range of appraisal procedures and approaches, result in a reliable conclusion of value. Calculations are less comprehensive, so they provide merely a rough estimate.

The calculated value is based on procedures agreed upon in advance by the business owner and appraiser. These procedures are outlined in the engagement letter, and the calculation's limited scope is disclosed in the valuation report. Calculations have limited applicability.

To illustrate: Suppose a long-time business owner wants to know what his company is worth. He can request data on recent sales transactions. The expert agrees to analyze private transaction databases and calculate the median price-to-earnings multiple of similar companies in the same industry sold within the last several years. As an alternative, the appraiser could use the discounted cash flow (DCF) method, which focuses on the present value of the expected cash flows.

This limited-scope engagement generates a calculated value. If the owner is merely curious, the work stops here. But if the owner subsequently decides to sell, he needs to obtain a full valuation report. When the appraiser is free to apply all appropriate valuation methods, this expert's opinion might differ significantly from the preliminary value calculation.

Calculations and valuations are not synonymous. Calculations can work in limited circumstances, say, as a preliminary indicator to satisfy management's curiosity. But they're not reliable, independent opinions of value.

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John M. Leask II CPA, LLC.

Business Valuation Services

765 Post Road, Fairfield, Connecticut 06824

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FAIRFIELD, CT

John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.***
The fax is ***203 - 380 - 1289****, and e-mail is* ***Mac@LeaskBV.Com****.*

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.