

What's It Worth?

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Consulting and Valuation Services Group

Marketability discount not appropriate where comparables were also closely held companies

Hanson v. Hanson, 2004 Ore. App. LEXIS 230 (March 10, 2004).
Judge Hasleton.

One issue in this marital dissolution was the fair market value of **Northwest Stamping, Inc.** (NSI), a closely-held S corporation. The court of appeals determined the trial court's valuation was proper and upheld its ruling.

Facts

The parties purchased NSI in 1991, during the marriage. NSI designs and produces high-tech components using precision stamping machinery for various industries. In 1999 the parties jointly hired **William Mason** to value the company in connection with their separation. In 2000 wife filed for dissolution.

Valuation evidence

At trial both parties offered the testimony and reports of valuation experts. Mason and **Donna Walker** testified on behalf of wife. **William Holmer** testified on behalf of husband. All the experts prepared reports using a combination of the capitalization of earnings method (income approach) and the comparable transaction methods (market approach). The valuation conclusions of the experts and the court are shown in *Table 1*. Only Holmer applied a discount for lack of marketability.

Trial court findings

The trial court adopted Mason's December 31, 2000, valuation of the company holding that:

Despite the able arguments of Respondent's counsel, I find that a marketability discount is not appropriate in this particular case. ... with regard to the argument that the Court of Appeals

Court corrects double counting of husband's income

In re Marriage of Frett, 2004 Iowa App. LEXIS 694 (May 14, 2004). Judge Nelson.

The issue in this marital dissolution was the value of husband's telephone equipment business, **TechniCom, Inc.** Prior to the dissolution hearing, husband increased his pay from \$64,000 to \$100,000, to reflect the assumed basis of temporary child support calculations.

Valuation evidence

TechniCom's business assets were worth \$100,000 and it had retained earnings of \$550,000. **Wayne Brown** testified that the value of the company was \$1,030,000. Brown used the income valuation method and assumed husband's salary was \$64,000. He also discounted the company by 10% for lack of marketability.

Dennis Redmond also used the income valuation method but discounted the company 15% for lack of marketability and 20% for a key person discount, "to show as a percentage discount the risk of potential loss of a key person to the company." Redmond as-

TABLE 1: EXPERTS' VALUES & COURT'S CONCLUSIONS

Expert	As of date	DLOM	FMV
Mason (jointly retained)	Sept. 30, 1999	None	\$6.9 million
Mason (for wife)	Dec. 31, 2000	None	\$5.7 million
Walker (for wife)	Feb. 2001	None	\$5.9 million
Holmer (for husband)	Dec. 31, 2000	25%	\$3,646,731
Court	Dec. 31, 2000	None	\$5.7 million

in *Tofte and Tofte*, 134 Ore. App. 449, 895 P.2d 1387(1995) mandates that a marketability discount be applied to all controlling interests of non-publicly traded companies, I reject that argument. The passage cited is in a footnote and the case involved a *minority* interest, not a majority interest. That this topic is hotly debated is clear from the record in this case.

Holding on appeal and rationale

The court of appeals affirmed the trial court's opinion. The court was careful to point out that marketability discounts could be applied in cases where the interest was a majority interest stating, "[T]he court did not hold that a marketability discount can *never* be applied—only that, in the circumstances of this case, such a discount would be improper. The trial court was correct in that conclusion." The court indicated that a discount for lack of marketability would be appropriate in valuing a closely held company where comparables that were used were public companies. In this case, however, all the comparables used were closely held companies.

The court also discussed the distinction between a discount for lack of marketability and a minority interest discount.

sumed husband's salary was \$100,000 and concluded that the company was worth \$590,000.

Trial court findings

"The [trial] court imputed all of the profits of TechniCom as income to [husband] and found his average income over the past five years was \$332,604. The court ordered [husband] to pay child support of \$4417.09 per month." The court also divided the company based on Brown's valuation of \$1,030,000.

Holding on appeal and rationale

The court of appeals ruled that under the facts of the case, Redmond's discounts were excessive. It also determined that the trial court's conclusion resulted in double counting. The court of appeals concluded that the husband was making \$100,000 a year and thus lowered the value of the company to \$855,000. In addition, the court determined that his actual salary should be the basis of child support, and therefore lowered the child support to \$1500 per month.

LLC and limited partnership transfers are valid to reduce estate tax

***Kimbell v. Commissioner*, 2004 U.S. App. LEXIS 9911 (May 20, 2004).** Judge Davis.

In this estate tax case, the Fifth Circuit vacated and remanded the district court's granting of summary judgment to the Commissioner on the grounds that that the transfer under IRC §2036 was a bona fide sale for full and adequate consideration.

Facts

In January 1998, the decedent's living trust, along with her son and daughter-in-law, formed an LLC. The trust contributed \$20,000 for a 50% interest, while the son and daughter-in-law contributed \$10,000 each for a 25% interest. Later that month the decedent's living trust and the newly formed LLC formed a limited partnership. The living trust contributed \$2.5 million worth of cash and assets in exchange for a 99% limited partnership interest. The LLC contributed \$25,000 for a 1% general partnership interest. The decedent's son managed both the LLC and the limited partnership. Decedent continued to hold approximately \$450,000 in assets for living expenses outside of the LLC and limited partnership.

Valuation evidence

The estate's federal return claimed a 49% combined minority and lack of marketability discount. The tax return concluded that the fair market value of the decedent's interest in the limited partnership was \$1.2 million and the fair market value of the LLC interest was \$17,000.

The IRS audited the estate and concluded that the assets were subject to IRC §2036(a), which recaptures certain assets prior to death.

Trial court findings

At trial, the IRS successfully argued that the transferred assets could be recaptured because the transaction was not a bona fide sale for full and adequate consideration. The district court, which defined an arm's-length transaction as one involving "two parties who are not related..." concluded that the transaction was not at arm's length because the parties were related and therefore the transaction was not bona fide.

The district court accepted the IRS's conclusion, and granted partial summary judgment on that rationale.

Holding on appeal and rationale

In its opinion vacating the district court's opinion, the Fifth Circuit

stated, "[t]he government's inconsistency argument . . . is a classic mixing of apples and oranges: The government is attempting to equate the venerable "willing buyer-willing seller" test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under § 2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid — a classic informed trade-off."

The court of appeals concluded that the facts of the case supported the contention that the transaction was bona fide. They included:

- (1) Mrs. Kimbell retained sufficient assets outside the Partnership for her own support and there was no commingling of Partnership and her personal assets...
- (2) Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership...
- (3) The assets contributed to the Partnership included working interests in oil and gas properties which do require active management...
- (4) David Kimbell and Michael Elyea advanced several credible and unchallenged non-tax business reasons for the formation of the Partnership that could not be accomplished via Mrs. Kimbell's Trust...

Specifically, the court found that a living trust would not provide legal protection from creditors as a limited partnership would, because with the partnership, all the capital assets could be pooled, thereby reducing administrative costs and keeping all accounting functions together.

The court of appeals concluded that the transaction was bona fide for full and adequate consideration as a matter of law and remanded to the circuit court the issue of whether Mrs. Kimbell's interest in the Partnership was an assignee interest or limited partnership interest.

Continued enjoyment of property leads to disregard of FLPs

***Estate of Abraham v. Commissioner*, 2004 Tax Ct. Memo LEXIS 41 (February 18, 2004).** Judge Ruwe.

The issue in this estate tax case was whether three family limited partnerships (FLPs) should be respected for estate tax purposes.

The decedent, Abraham, had numerous properties that were placed in three FLPs for purposes of estate planning. Decedent continued, by way of her appointed guardian, to benefit from those properties until her death, exclusive of the other partners, who were her children.

The estate engaged **Michael Lipof**, a real estate consultant, to value the FLPs for the estate tax return. In doing so, Lipof applied a discount of 30% to 40% to the asset value of each FLP to determine the fair market value of the FLPs.

The IRS filed a notice of deficiency, claiming that most of the assets held by the FLPs should be included in Abraham's gross

estate under Section 2036.

Tax Court findings and rationale

The Tax Court noted that the decedent by definition violated Section 2036 by continuing to enjoy the property held by the FLPs. "Possession or enjoyment of the property transferred is retained where there is an express or implied understanding among the parties at the time of the transfer, even if the retained interest is not enforceable."

The Tax Court concluded that the FLPs were "merely a testamentary vehicle employed to shift her assets to future generations while maintaining her continued right to benefit from the FLP interests transferred. This is precisely the type of situation for which Section 2036 was created." The Tax Court disregarded the FLPs and valued the property held in the FLPs at full fair market value.

Cost Segregation

By David G. Moser, ASA, Director of Consulting and Valuation Services

Have you acquired property outright or in an exchange?

Are you planning to build?

Are you planning to sell?

If you answered yes to one of these questions, Coulter and Justus, PC would like to talk with you about ensuring that you maximize the property depreciation deductions available to you. The process is called Cost Segregation and it's all about analyzing and properly separating construction project costs by function according to the depreciation provisions of the Federal Tax Code (MACRS).

If you combine the proper use of MACRS with the additional first year depreciation provided by the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 you are looking at your own mini tax relief act.

How can a Cost Segregation study help if you have owned your building for several years?

Even if you acquired your building many years ago, a recent IRS revenue procedure allows property owners to "catch up" all missed depreciation *without* amending tax returns. Consider this simplified example:

Your \$10MM "generic" office building is being depreciated as all 39 year property. Our experienced staff review the plans, tour the building, and find nearly \$150,000 of special use items throughout the building that should be 5 or 7 year. They also find that over \$100,000 of site work should be 15 year life. When we look at the cumulative effect of this for the five years you've been depreciating the building, we find about \$110,000 to deduct this year, in addition to changing your annual deduction from \$25,000 to \$65,000. (If your numbers are not that large, just drop a zero, the math still works.)

Please review the enclosed reference materials and see for yourself what such a study could do for your business.

About US

Coulter & Justus is a professional service firm with over 70 years of local and regional experience in accounting, tax, and specialized services.

Our Consulting & Valuation specialists have 50 combined years of full time experience on nearly 1,000 projects, including close to 100 cost segregation projects representing over \$5 billion.

Please contact David Moser or Renee Harwell for more information. Our initial consultation is free and we will work closely with your tax advisor.

FREQUENTLY ASKED QUESTIONS

Who can do a Cost Segregation study?

Valuation or engineering professionals with cost estimating experience who also understand the tax code, working closely with your tax advisors.

Wouldn't my accountants have performed a Cost Segregation Study for me?

Not unless they employ or collaborate with appraisal professionals with cost segregation experience and you specifically asked them to perform such a study.

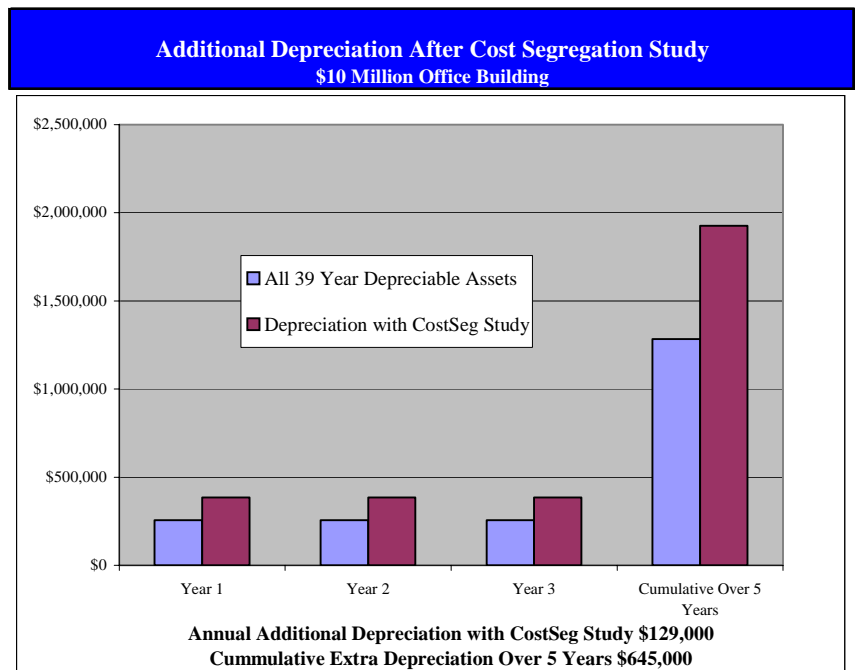
What is the payback on doing such a study?

- On a \$1,000,000 manufacturing plant, first year tax saving alone could be \$50,000.
- On a \$250,000 restaurant, first year tax saving alone could be \$40,000.
- On a \$1,000,000 office, first year tax saving alone could be \$30,000.

What are typical fees for such a study?

Our fee estimates depend mainly on the ease of obtaining the necessary data to conduct the analysis. We provide an estimate and written quote for each project.

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Cost Segregation for Various Property Types

Building Type	Size to Justify CostSeg Study	% Likely to Qualify as 5 or 7 Year Property
Apartments	\$750,000	10% - 15%
Hotels/Motels	\$750,000	10% - 20%
Offices	\$1,000,000	12% - 20%
Medical Office	\$750,000	15% - 30%
Warehouses	\$1,000,000	5% - 15%
Manufacturing	\$1,000,000	25% - 40%
Process Plants	\$500,000	50% - 80%
Restaurants	\$250,000	45% - 60%

Cost Segregation

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How far back can we go?

The IRS has waived a rule that required real estate owners to wait two years before switching depreciation methods. Revenue Procedure 2004-11 enables real estate investors to switch their depreciation method in any year. Further, if an investor sold a property in the very same year the depreciation method was changed, or if an investor claimed less depreciation than would be allowed under Cost Segregation, the investor can recoup depreciation related tax savings for prior years.

What if I decide not to have a Cost Segregation study done?

If you depreciate a 7-year asset over 39 years, the IRS could disallow the regular depreciation on the asset beginning in the eighth year. And, if the building is sold, the IRS could increase the gain by reducing the basis by the depreciation that *should have been taken* in prior years but was not. And don't forget about the impact of bonus depreciation as well.

Will the Cost Segregation study impact estate planning?

It may. Due to the "step-up in basis" rules, when a building passes from an owner to his/her heirs, it is important to start the depreciation process over at the heirs' higher basis and a Cost Segregation study provides the appropriate breakdown to do so.

Do my chances of being audited increase?

According to the IRS, "No". Keep in mind that you are changing from an incorrect depreciation method to a correct method.

What kind of support do I have in the event of IRS questions (or an audit)?

There are numerous IRS rulings, procedures and court cases which allow for Cost Segregation. The thorough, properly

prepared report that Coulter & Justus provides will detail every change made and the work papers document these changes.

What if I don't expect to pay much tax for 2004, and maybe even for 2005?

If your business does not expect to pay any tax for 2004, the immediate value of a project is going to be less. BUT, even if the first year tax saving benefits don't seem to be there, it still makes sense to do a Cost Segregation analysis if:

- the business was previously in a tax-paying mode and could file for a refund.
- you have near term plans to sell, do the math: tax rate of 39% vs. 25% on recaptured amount of depreciation = a 14% advantage during the ownership period.
- in a near term sale situation, the IRS could and has argued that not enough depreciation has been taken because the asset was improperly classified and thus under depreciated.
- you write-off assets' remaining costs by having pre-identified the basis of items likely to be replaced.

What if I acquired or plan to acquire property via a tax-free exchange?

Speak to us. The principles of Cost Segregation still apply in the case of 1031 exchanges.

What if I lease and just have leasehold improvement costs?

Cost Segregation applies to leasehold improvement costs and the benefit here can be significant. Speak to us ASAP.

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COULTER & JUSTUS, P.C.

CONSULTING & VALUATION SERVICES GROUP

Our Consulting and Valuation Services professionals have over 50 years of combined experience involving more than 1,000 projects. We understand the significant financial and emotional impact valuation plays in our clients' lives, whether to settle an estate tax or in litigation, or to buy or sell. Additional services include cost-segregation studies and mergers & acquisitions representation.

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David is a certified Senior Member of the American Society of Appraisers (ASA), and has over 33 years experience in the valuation profession. Before joining Coulter & Justus in 1996 he served in valuation management positions with Ernst & Young and two other international valuation firms. He has considerable experience in business valuations, cost segregation, and as an expert witness.



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Sven has a total of 12 years of experience in business valuation and investment banking including financial restructuring/Chapter 11 advisory work and mergers & acquisitions. He joined Coulter & Justus in 2003 and also holds an MBA degree with an emphasis in Finance from New York University's Stern School of Business.



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Renee joined Coulter & Justus in 1999 and has eight years of business valuation experience. She has valued businesses for purposes including mergers, estate tax and gifting, litigation, bankruptcy reorganization, and in performing cost segregation analysis. Renee also has troubled business turnaround and controllership expertise, in addition to tax and audit experience.



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Cindy has over 12 years client service experience in the areas of auditing, budgeting and finance, and general business consulting. She joined Coulter and Justus in 1997 as a Business Valuation Consultant.



Contact one of our valuation professionals directly via email, or call 865.637.4161 to reach Coulter & Justus, PC