fall
2004

Valuation Concepts

inside: Recent FLP victory <> Complex marital estates

Times of transition call for liquidation analysis

Most business valuations focus on a company's going concern value, or its value in continued operation. During times of crisis or major change, however, owners and creditors may seek insight into a company's liquidation value — or how much money the company would be worth if it ceased operations, sold its assets and paid off its outstanding debts.

Useful valuation tool

Liquidation analyses are imperative for clients facing formal bankruptcy proceedings. Not only can they be useful in court, but they can also help faltering companies decide whether they should opt for Chapter 7 (reorganization) or Chapter 11 (liquidation).

Companies attempting to sidestep formal bankruptcy proceedings through an out-of-court turnaround can use liquidation analyses to persuade creditors that they will receive more if they support the company during its turnaround than if they force it into involuntary bankruptcy.

Companies also obtain liquidation analyses to assess the reasonableness of purchase offers. Many smaller business owners not only lack merger and acquisition experience, but they also tend to be emotionally attached to their businesses. A liquidation analysis can establish a "floor" for the company's value and serve as a benchmark to help management decide whether to sell the company.

Liquidation analyses can further help larger companies contemplating a purchase offer. This is especially true when management proposes the buyout or when minority investors and creditors are likely to oppose the sale. When unbiased valuators perform liquidation analyses, they can demonstrate that the board acted in good faith and exercised reasonable business judgment.

Forced or orderly liquidation

Before calculating a liquidation value, appraisers must know whether a company will be participating in a forced or orderly liquidation. In the first scenario, the company sells its assets quickly in a "fire sale" or auction. In an orderly liquidation, the company's assets are sold over a reasonable timeframe to maximize sale proceeds.

To decide which type is appropriate, companies should talk with attorneys and valuation experts to decide which scenario makes sense given their own preferences, relevant statutes and legal precedents.

Calculating value

Appraisers begin the actual valuation with the company's balance sheet — which is adjusted to reflect the items' current market values rather than their historic cost. The face value of liabilities reported on a company's balance sheet is generally fairly accurate. Assets may, however, require some reassessment.

Valuators sometimes increase the asset values to reflect differences between accounting norms and market value. For example, for record-keeping simplicity, some companies use accelerated tax depreciation methods for book purposes, which tend to understate the net value of newer machinery and equipment.

On the other hand, some assets require downward adjustments. For example, outdated inventory records may contain obsolete items or the accounts receivable ledger may include bad debts. Downward adjustments are generally more common when assessing a company's value under forced liquidation, because time constraints can dramatically limit assets' recoverability.

After adjusting the balance sheet, valuators assess whether contingent or unrecorded items exist. Some identifiable intangible assets may be salable in liquidation, such as customer lists, patents and proprietary software. When these items are developed in-house, they're generally excluded from the balance sheet.

Examples of unreported liabilities include tax audits and pending lawsuits. Another important liability valuators generally consider is liquidation expenses — such as remaining rental obligations, severance pay and professional fees — that the company will incur as its operations wind down.

Better decisions

No matter why a company seeks a liquidation analysis — bankruptcy, merger or sale — this vital information can help management and other interested parties make more informed decisions.

Recent FLP victory provides hope for estate planners

Does your client's family limited partnership (FLP) have what it takes to withstand an Internal Revenue Code (IRC) Section 2036(a) challenge?

Section 2036(a) provides that a decedent's taxable gross estate includes the value of all transferred property that the individual nevertheless retained possession of or enjoyment from during his or her lifetime. Because the IRS has used it to make several successful attacks on FLPs, some experts have dubbed it the "Achilles heel" of FLPs.

But in a recent appellate court decision (*Kimbell v. U.S.*, 5th Cir., May 20, 2004), the estate successfully defended itself by proving that its FLP transfers were bona fide. This provides hope that other FLPs will successfully withstand future IRS challenges.

Kimbell case

Prior to her death in March 1998, Ruth Kimbell gradually transferred a large portion of her estate to three entities: a revocable living trust, a limited liability company (LLC) and a Texas FLP. Kimbell, through the trust and the LLC, owned 99.5% of the partnership. She also retained more than $450,000 in assets outside of the LLC and the partnership for her personal expenses.

As a result of the decedent's transfers, the partnership's underlying assets included cash, oil and gas interests, securities, notes and other assets. At the time of Kimbell's death, the partnership's net asset value was approximately $2.4 million, to which the estate applied 49% combined discount for lack of control and marketability.

A Texas district court upheld the IRS's contention that the value of assets Kimbell transferred to the partnership was includible in her gross estate, because the transfer was not a bona fide sale for full and adequate consideration. The estate appealed this decision.

Appellate court decision

Fortunately for Kimbell's estate, the appellate court vacated the lower court's decision, which it based on two tests:

1. **Bona fide transaction test.** If an estate can show that it received "full and adequate consideration" for a transfer (an asset roughly equivalent to the asset given up), Section 2036(a) does not apply to the FLP.

   The Fifth Circuit carefully differentiated the terms "full and adequate consideration" and "fair market value." The court stated that a transfer's fair market value can be less than the full and adequate consideration the transferor effectively received, because investors consider other objectives when purchasing limited partner interests.

   The court also pointed out that neither intrafamily transfers nor tax planning motives prevent a sale from being deemed bona fide if the transaction otherwise appears "real, actual and genuine."

2. **Retained interest test.** FLPs can escape Section 2036(a) if the transferor gives up all control over the asset transferred. To prove that the transferor retains an interest in the assets transferred, the IRS must show that the parties have an express or implied agreement entitling the transferor to continued use or enjoyment of the property. Further, if the transferor retains control over the entity that received the assets, Section 2036(a) may apply.

Even though family members were present on both sides of the transfers, the Appeals Court found that the Kimbell estate successfully demonstrated that it had received full and adequate consideration for the decedent's transfers. Because the transfers qualified for the bona fide transaction exception, the court did not address whether the retained interest test applied to the partnership.

The Appeals Court also decided that Kimbell had been properly credited for a partnership interest proportionate to the assets she transferred. On termination and liquidation, the partnership agreement required distribution to the partners based on their capital accounts.

Kimbell had also retained sufficient assets outside the partnership for her own support, and there was no commingling of partnership assets and her personal assets. Additionally, partnership funds were not used to pay Kimbell's personal expenses.

What this means

The Kimbell decision is good news for taxpayers seeking ways to transfer wealth to the next generation. This case, along with a similar Tax Court ruling in *Estate of Stone v. Commissioner* (T.C. Memo 2003-309), suggests that estate planners may be able to protect their clients' FLPs from IRS attacks under IRC Section 2036(a) by doing the following:

- Erect a wall between FLP assets and personal assets.
- Establish a clear business purpose for the FLP.
- Retain sufficient funds for the FLP founders to maintain their accustomed standard of living.
- Continue the FLP's operations according to its original business objectives after the founder's death.

Proper planning

The IRS has become increasingly aggressive in challenging FLPs in recent years. But with proper planning, you may be able to head off unwelcome government scrutiny.

Complex marital estates demand valuation expertise

When business owners divorce, they often require supplemental financial expertise beyond the advice their attorneys can provide.

Divorce attorneys focus on the legal aspects of marital dissolutions. But few feel qualified, for example, to value an interest in a closely held business, to differentiate personal goodwill from business goodwill or to offer advice on the value of other complex marital assets, such as stock options or professional licenses. Furthermore, as advocates for their clients, attorneys' opinions on such financial matters cannot be used in court.

Valuation professionals, on the other hand, are ideally positioned to help divorcing spouses handle these financial matters. Many have extensive divorce case experience and can act as objective experts.

Divorce experience

Divorce cases differ significantly from other types of valuation assignments. For instance, many states require valuators to separate the company's value into three components: net tangible value, personal goodwill and business goodwill. In most jurisdictions, portions of goodwill may be excluded from the marital estate to avoid "double dipping."

Additionally, when closely held business interests are premarital assets, valuators typically need to calculate the interest's net appreciation (by subtracting its premarriage value from its current value). Valuation experts are also familiar with these divorce case nuances:

- *Active-passive approach.* As a general rule, "active assets" — those with values contingent on the spouse's day-to-day involvement — are valued as of the date of the divorce filing. Conversely, "passive assets," which are more closely linked to external factors beyond the spouses' control, such as market conditions, are typically valued as of the trial date.
- *Preferred valuation methods.* Because discounted cash flow techniques are perceived as complicated and subjective, family court judges tend to prefer the market approach or the excess earnings method. When the discounted cash flow method is appropriate in a divorce case, an experienced valuator will likely reconcile this method with the market approach and capitalized cash flow method.

- *Asset dissipation*. Spouses sometimes attempt to reduce the value of their business interests by understating income, overstating expenses or hiding assets. Experts with previous experience valuing businesses for divorce purposes are familiar with the warning signs of fraudulent behaviors and can adjust the company's value accordingly.

Objectivity

Family courts are usually skeptical of expert witnesses. To safeguard an expert's perceived objectivity and professionalism, choose one with recognized valuation credentials and previous divorce experience.

Also ask whether the valuator has served an equal number of monied and nonmonied spouses. Unlike attorneys, valuators shouldn't necessarily specialize in one side or the other — those who do may be perceived as hired guns. Valuators must walk the fine line between advocacy and independent expertise.

Early involvement

To ensure your client's valuator provides the most reliable, accurate opinion possible, involve him or her from the case's onset. When valuators are hired during the discovery stage, they can help attorneys construct lists of documents to subpoena.

Even the most amicable divorces become adversarial with the passage of time. Therefore, it's often prudent for attorneys representing nonmonied spouses to proactively seek formal court approval of certain valuation procedures that monied spouses may refuse in the future, such as facility tours and personnel interviews.

Ongoing communication

Although valuation experts generally refrain from advocacy, they should be kept abreast of a case's latest developments. From beginning to end, attorneys should communicate relevant case law and the specific judge's preferences.

If trial dates change, new information becomes available or settlement appears imminent, contact your valuation expert to prevent costly last minute changes, unreasonable time delays or embarrassing courtroom mishaps.

Better outcomes

Divorce cases involving large amounts of money and complex assets require expert analysis. Choose your valuation expert carefully and you can improve your client's chances for a favorable outcome.