Viewpoint on Value

November/December 2015

Year end gifts: Valuing a business for transfer tax purposes

Spotlight on reasonable pay
IRS job aid can be a useful resource for estimating owners' compensation

What's the value of my franchise?

Back to basics
When to consider ex post facto information

Do you have a **Question?** or want to speak to

Michael B. Lehner
CPA/ABV, CFE, ASA

zbt Certified Public Accounting & Consulting, LLC

Michael B. Lehner, CPA/ABV, CFE, ASA
732.412.3825
mlehner@zbtcpa.com
www.linkedin.com/in/michaellehnercpa
@MLehnerCPA
BusinessValuationNJ
www.zbtcpa.com

Year end gifts: Valuing a business for transfer tax purposes

The end of the year is a time for gift giving. In 2015, taxpayers can transfer $14,000 per recipient under the annual gift tax exclusion free of federal gift tax without using any of their $5.43 million lifetime exemption. Over time, annual gifts of closely held business interests add up and can substantially lower the amount of taxes that a business owner's estate will eventually owe — especially if the owner employs estate planning tools that allow valuation discounts.

Estate planning tools

Estate planning tools such as family limited partnerships (FLPs), family limited liability companies and various types of trusts can reduce gift and estate taxes even more than outright gifts of business interests. In a typical FLP arrangement, for example, the business owner forms a limited partnership to own a closely held business (or an interest in the business) and then transfers limited partnership interests to his or her family members.

By maintaining a small ownership interest in the FLP and acting as general partner, the business owner retains the right to manage the business indefinitely. And family members receive ownership interests in the business that are largely protected against claims from creditors.

Valuation discounts

Gifts of closely held business interests may be entitled to valuation discounts to the extent that they lack control and marketability. Control refers to whether an owner has "the power to direct the management and policies of a business enterprise." In the case of FLPs, limited partners, by definition, have very little control over the partnership's decision making.

Marketability refers to "the ability to quickly convert property to cash at minimal cost." Closely held business interests take time to sell and, therefore, tend to lack marketability compared to shares of publicly traded stock. In the case of FLPs, partnership agreements may contain additional transfer restrictions and other limiting provisions that make limited partner interests less attractive to unrelated investors and, therefore, may warrant higher marketability discounts.

Substantiating value

Estimating fair market value (FMV) near or at the date of gift is critical when filing gift and estate tax returns. The IRS defines FMV as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

An independent qualified appraiser can help. Numerous taxpayers have won or lost matters before the U.S. Tax Court and other federal courts based

Truth or rumor: Are valuation discounts in jeopardy?

Recently there's been speculation that the IRS will soon propose rules that would disregard "other restrictions" when determining the value of a transfer to a family member if the restriction doesn't ultimately reduce the value of the interest to the transferee. In fact, it's possible such rules will have been proposed by the time you're reading this. (Check with a valuation professional or your tax advisor for the latest information.) Such rules might significantly reduce the discounts available to family limited partnerships (FLPs) that hold marketable securities or real estate, even if the FLPs were established for nontax purposes.

It's likely that any IRS proposal would be effective *prospectively*, so gifts made before the rules are finalized probably won't be affected — providing an added incentive to business owners who want to gift FLP interests to act before year end.

on the qualifications, methods and testimony of their valuation experts.

Taxpayers also may be subject to significant monetary penalties for undervaluing transferred business interests. Taxpayers can trigger a 20% penalty for a *substantial* valuation misstatement if the reported value was 65% or less than the "correct" value. They can trigger a 40% penalty for a *gross* valuation misstatement if the reported value is 40% or less than the correct value.

The IRS allows an exception to its valuation misstatement penalties if a taxpayer can demonstrate that it acted with reasonable cause and in good faith. One way for taxpayers to prove that they qualify for this exception is to hire "qualified appraisers" to perform "qualified appraisals."

Qualified appraisers and appraisals

A *qualified appraiser* has earned an appraisal designation from a recognized business valuation organization. It's also important for the expert to have appropriate education and experience in valuing closely held businesses.

A *qualified appraisal* is a detailed written appraisal report that discloses the following information:

- A detailed description of the contributed property,
- A statement that the appraisal was prepared for federal tax purposes,
- FMV on the date of contribution,
- Methods used to value the business interest, and
- Any specific data that the appraiser used to determine FMV.

Abbreviated formats may raise a red flag when they're used to support FMV for transfer tax purposes. Additionally, a valuator's written report typically serves as his or her direct testimony if the return winds up in U.S. Tax Court.

Act now

Over the years, annual gifts can add up and reduce a business owner's estate tax bill. The savings are even more substantial when taxpayers take advantage of FLPs, trusts and other estate planning vehicles that may warrant valuation discounts. ●

Spotlight on reasonable pay

IRS job aid can be a useful resource for estimating owners' compensation

Last fall, the IRS published *Reasonable Compensation: Job Aid for IRS Valuation Professionals*. Field agents use this publication when auditing 1) C corporations suspected of overpaying owners (in lieu of paying dividends) to avoid double taxation and 2) pass-through entities that underpay owners to minimize payroll taxes.

Business valuators also use the job aid to help owners know how much their contributions are worth in today's marketplace, based on their duties, skills and experience. Here's an overview of how the IRS and valuators systematically approach this large discretionary expense.

Covering all the bases

The term "reasonable compensation" refers to how much a third party could expect to be paid for performing the same duties for the subject company. Owners' compensation may include items such as salaries, payroll taxes, benefits, stock options, zero-interest loans, paid time off, discounts and other perks. The IRS job aid advises that owners' compensation expenses may also be buried in such accounts as management and consulting fees, rent expense and covenants not to compete.

Actual owners' compensation may vary from reasonable compensation if an owner has, say, unique skills or experience that warrants higher pay. The job aid provides guidance on unusual circumstances that may warrant a disparity in pay. For example, some companies may be trying to "catch up" for paying below-market salaries when cash was tight during the recession. Or an owner may feel entitled to an above-market salary for personally guaranteeing the company's debt.

Finding comparables

Valuators take many factors into account when identifying comparables to use to estimate reasonable compensation. A succinct job description helps pinpoint the owner's duties. Some contribute so much to the business that multiple individuals would be needed to replace them. Appraisers also consider the owner's education, training, licenses, salary history and hours worked.

Beyond the owner's personal attributes, valuators may consider the size and financial condition of the business, geographic location, industry trends, and the state of the economy.

Appraisers frequently support their reasonable compensation estimates with market research. The IRS job aid specifically lists these sources of market data:

- General industry surveys by Standard Industrial Classification (SIC) or North American Industry Classification System (NAICS) code,
- Salary surveys published by trade groups or industry analysts,
- Proxy statements and annual reports of public companies, and
- Private company compensation reports such as data published by Towers Watson, Dun & Bradstreet, the Risk Management Association or the Economic Research Institute.

Finding comparable companies (and individuals within those companies) can be a daunting challenge, however.

Applying compensation data to valuations

When valuing a business, owners' compensation becomes relevant because it's a large expense that's typically dependent on the owner's discretion rather than on an arm's-length negotiation. The higher an owner's compensation is, the lower the company's value will be — unless an adjustment is made.

When valuing a business on a controlling basis, valuators typically adjust actual owners' compensation to reflect reasonable compensation. Discretionary adjustments — including owners' compensation — might not be made when valuing a minority interest in the subject company.

Reasonable compensation is also relevant in divorce cases, because child support and maintenance payments often are based on an owner's salary. Some unscrupulous business owners might try to pay themselves below-market wages to minimize those payments.

Owners may also use valuators to help decide how much to pay themselves — or the next generation of owners. Some owners have worked for themselves for so long that they don't know how much their services would be worth in today's marketplace. In other cases, the next generation of owners might expect to be paid the same as their successors, even though they may lack experience or an outside work history. Objective market data can be a wake-up call for all managers, young and old alike.

The higher an owner's compensation is, the lower the company's value will be — unless an adjustment is made.

Staying objective

Owners' compensation varies significantly from company to company. Some owners treat the company's bank account like a personal slush fund. Others draw minimal salaries from the business, because they undervalue their contributions or because the business is cash poor. Quantifying what's "reasonable" can turn into an emotionally charged debate. Fortunately, valuators can provide objective market data to help defuse emotions and keep the parties focused on financial matters. ●

What's the value of my franchise?

The International Franchise Association estimates that there are currently more than 2,000 different brands operating over 700,000 franchised units in the United States. Based on the number of people who own franchises, it may *seem* like an easy route to owning a private business. But not all franchises are created equal, resulting in unique valuation challenges.

Risk assessment

As with any business, the value of a franchise is a function of risk and return. A franchised business may seem to carry little risk because its brand is established and the franchisor provides administrative support, including marketing programs, accounting systems, operating manuals and training. The franchisor also may pass along volume purchasing discounts from suppliers to its franchisees.

All of these factors suggest that a franchise is significantly more valuable than an otherwise identical standalone business. But that's not always the case for a variety of reasons.

Return on investment

The franchisor's support comes at a substantial cost, which lowers the franchisee's return. First, the owner must pay an upfront franchise fee, which typically ranges from about $50,000 to $200,000, though some franchise fees may be higher or lower depending on the brand and geographic market. Additionally, the franchisee must pay professional fees to get started.

Once open, the franchisee must pay ongoing royalties that typically range from 4% to 8% of gross revenues and include an ongoing assessment for a joint marketing and advertising fund. The franchisee also may be required to purchase uniforms, inventory and other supplies from the franchisor, as well as build out (or update) the facilities to comply with the franchisor's appearance standards.

As a result of these costs, most franchisees don't report positive operating cash flow until they've been in business for several years. To help forecast revenue and costs, a valuator will ask for a copy of the franchise disclosure document. Required by the Federal Trade Commission, this document provides insight into start-up costs and fees, average monthly sales and projected revenue growth.

Restrictive covenants

A franchised business may look even less attractive to investors if the franchisor restricts the owner's actions. Examples include independent marketing efforts, relocation and ownership transfers.

Valuators typically review the franchise agreement to get a handle on these restrictions. A discount may be warranted if the agreement limits the franchisee's rights to expand, sell to a third party or respond to changing trends and market demographics.

Industry trends

Franchisees are most satisfied when franchisors continually reinvent their brands and offerings, invest in training programs, support customer retention efforts and grant flexibility to respond to changing market conditions. Strong franchisors also adapt to regulatory challenges, such as changes in health care reporting and the minimum wage and overtime rules. Valuators ask, "How do this brand and its industry measure up to others?"

The *Franchise Business Review* named these five industries as the top franchise groups of 2015, based on franchisee satisfaction:

1. Advertising and sales,
2. Education,
3. Senior care,
4. Real estate, and
5. Child services.

Sports and recreation franchises deserve an honorable mention for nearly tying with child services for fifth place. The *Franchise Business Review* expects more sports and recreation franchises to emerge in 2016 and beyond.

Broad due diligence

Franchises offer investors many pros and cons. When valuing a franchise business, appraisers look beyond the person investing in the franchise and the specific location. Thorough due diligence includes evaluating the franchisor's business plans and the industry's overall prospects. ●

Back to basics

When to consider ex post facto information

Should business appraisers consider major events that occur after the valuation date? For example, what if a business is subsequently sold, files for bankruptcy, discovers new technological advances, or experiences a major fraud loss, data breach or natural catastrophe? All of these events could potentially affect a business's fair market value, but whether a valuator will consider a particular event depends on the facts and circumstances of the assignment.

Was the event known or knowable?

The general rule that applies to "ex post facto" information is: Was it known or knowable on the valuation date? If so, valuators will generally factor the event (or the risk of the event occurring) into their conclusions. But there are several exceptions.

For example, in *Estate of Jung v. Commissioner*, the U.S. Tax Court concluded, "Actual sales made in reasonable amounts at arm's length in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value." This case differentiated ex post facto information that *affects* fair market value from that which provides an *indication* of value.

If a subsequent event *affects* fair market value, the U.S. Tax Court will consider it only if it was known or reasonably foreseeable on the valuation date. But if a subsequent event provides an *indication* of value, it might be considered — even if it wasn't foreseeable — as long as it occurs within a reasonable time frame and at arm's length.

Would exclusion be "fair"?

In other courts, the concept of fairness may dictate whether a subsequent event will be factored into a business's value. For example, suppose that the parties in a divorce case stipulate to using the filing date (rather than the court date) to value all marital assets.

If the owner-spouse receives an offer to sell the business in the interim — or if its headquarters is subsequently destroyed in a tornado — the court may consider these events when equitably dividing the marital estate or calculating support payments. Similar fairness guidelines may apply in shareholder disputes.

Ex post facto information is also routinely considered when calculating lost profits. How a company performs after recovering from a breach of contract can help demonstrate how it might have fared "but for" the defendant's alleged wrongdoing.

When should subsequent events be disclosed?

When something major happens after the valuation date, immediately disclose it to your valuation professional. He or she can help determine whether the information was "known or knowable" on the valuation and whether exceptions to this guiding principle should apply. ●

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. In addition, any discounts are used for illustrative purposes and do not purport to be specific recommendations. ©2015 VVnd15