

Valuation Insights

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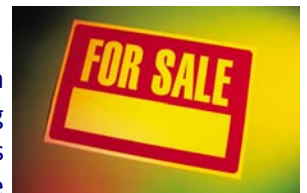
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The Importance of Business Valuation in Exit Planning

Studies indicate that over the next 20 years there will be an unprecedented number of businesses changing hands due to the retirement of millions of business owners from the baby boomer generation. It is also estimated that 90% of these businesses have not kept adequate records or documentation and are not prepared to sell. When is the best time to start the exit planning process? The answer is now! Why is it so imperative for a business owner to start the exit planning process now? Because few things are more important to business owners than the value of their business (as it is typically their single largest retirement asset). Furthermore, most business consultants agree that exit planning should begin at least three years prior to the anticipated "exit event" in order to maximize the sales price for the seller. Why is obtaining an independent, objective business valuation so important to the exit planning process? Let's explore this by looking at the two most common ways that business owners transfer their businesses.

Sale to a Third Party

The most common way that business owners exit their business is through a sale to a third party. Successful exit plans generally involve (1) establishing an accurate current value of the business; (2) establishing a desired sales price for the business; and (3) developing a strategy for how to increase the value of the business from its current value to its desired sales price. Virtually all business owners have an opinion as to their desired sales price. However, independent surveys show that most business owners don't have a firm grasp on the fair market value of their business and often misjudge the value of their business by 50% or more. Thus, in order to establish an accurate current value, it is vital to obtain an independent business valuation from a qualified business appraiser at the beginning of the exit planning process. Furthermore, it is best to work with a business valuation expert that will not only provide an accurate current value, but one that will also actively work with a business owners' accountant, attorney or other professional advisor(s) to devise a successful strategy that will create the additional value needed to achieve the desired sales price. In addition, depending on the time frame for the exit strategy, annual "update" valuations may also prove to be very beneficial as it allows a business owner to actively monitor the creation of additional business value to make sure that he/she is still on track to achieving their desired sales price.



Giftting and/or Selling to Children



Another popular way that owners exit their business is by gifting and/or selling the business to their children. It is also important (and often required) to obtain an independent business valuation from a qualified business appraiser when gifting or selling the business to children (or any other family member). Such appraisal is required to establish the value for gift tax purposes or to prove to the IRS that the transaction between related parties was an "arms length" transaction. Current gift tax laws for 2009 allow an individual to gift up to \$13,000 per person ("annual exclusion



amount”) to any number of people and none of the gifts are taxable. If an individual gives more than the annual exclusion amount to any one person in a single tax year then a gift tax return must be filed. However, he/she still may not have to pay gift tax as each taxpayer has a lifetime exclusion of \$1,000,000 that can be given during their lifetime without ever paying gift tax. Furthermore, a portion of the \$1,000,000 lifetime exclusion is utilized only when gifts to a single person in one tax year exceed the annual exclusion amount. For example, if you make a \$25,000 gift in 2009, you have used up only \$12,000 of your \$1,000,000 lifetime exclusion and you have \$988,000 remaining to utilize against future gifts.

If annual exclusion gifts are contemplated, a valuation is required to determine what percentage of the Company can be gifted to each recipient that equals \$13,000 of value. If gifts in excess of the annual exclusion amount are contemplated, then a valuation is still required to determine what percentage of the Company is gifted and the individual is required to file a gift tax return to report the gift. IRS regulations state that a “qualified appraisal” performed by a “qualified appraiser” must be included with the gift tax return in order to substantiate the value of the gift and to start the statute of limitations. Thus, it is important to utilize the services of an accredited business valuation expert (e.g. one that has obtained either the ASA, CBA, ABV or CVA business valuation designations) to assist with this process to ensure compliance with IRS regulations.

Obtaining an objective, independent business valuation is a vital component to any successful exit plan for business owners. If a business owner is planning on selling to a third party, they don’t want to make the mistake of failing to properly plan for the sale of their business and miss out on their best opportunity to maximize the sales price from quite possibly their largest retirement asset. If a business owner is planning on gifting a portion or all of their company to their children or other family members, it is imperative that they consult with estate planning specialists (e.g. accountants, attorneys, financial advisors and business valuation professionals) to help ensure that their estate planning goals are achieved and that they remain in compliance with IRS valuation and tax guidelines.

IRS Includes Appraisers in Definition of Return Preparers

The IRS issued its final regulations retaining its definition of appraisers among practitioners that can be called return preparers and subject to penalties under that section of IRS regulations despite much appraisal profession testimony at last Summer’s hearing on proposed regulations under section 6694. Final regulation explanatory language is outlined below:



“Appraisers”

Under Treasury Regulations in place since 1977 and the proposed regulations, an appraiser might be subject to penalties under section 6694 as a nonsigning tax return preparer if the appraisal is a substantial portion of the return or claim for refund and the applicable standards of care under section 6694 are not met. Several commentators have stated that appraisers should not be subject to penalties under section 6694 because they are subject to new, higher standards of conduct under section 6695A as set out in the Pension Protection Act of 2006, Pub. L. No. 109-280. The commentators have also urged that assessment of penalties under section 6694 against appraisers would result in imposition of a gratuitous and unnecessary layer of requirements and sanctions without any additional public policy benefit.

After consideration of the comment, the Treasury Department and the IRS continue to include appraisers in the definition of both signing and non-signing preparers, thereby providing the IRS with discretion to impose the section 6694 and 6695A penalties in the alternative against an appraiser depending on the facts and circumstances of the appraiser's conduct. The IRS, however, will not stack the penalties under sections 6694 and 6695A with respect to the same conduct. A separate regulation will provide guidance under section 6695A ." (The final regulation is published as T.D. 9436)

Estate of Thelma G. Hurford v. Commissioner, TC Memo 2008-278, December 11, 2008

I knew it was going to be an interesting case right from the start when the beginning of the memorandum findings of fact and opinion by Judge Holmes begins with "It is a truth universally acknowledged, that a recently widowed woman in possession of a good fortune must be in want of an estate planner." Furthermore, the memorandum findings end with "She lost her life to the cancer. We must now decide how much of her estate will be lost to taxes." The estate filed Form 706 and claimed Mrs. Hurford's taxable estate to be valued at \$846,666. The IRS audited both her gift tax return and estate tax return and assessed a deficiency of approximately \$9.8 million on her estate and \$8.3 million on gift tax returns, plus approximately \$3.6 million in penalties.

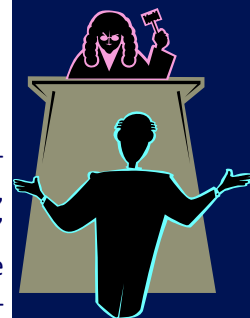
The court's main issue for decision was what should have been included in Mrs. Hurford's taxable estate (were her transfers to the FLPs and private annuity valid under Sections 2035, 2036 and 2038)?

The court ultimately found that the transfers were invalid and all estate assets were taxable at full fair market value. The court openly criticized the Estate's attorney for many errors, including sloppy drafting of key documents and making "egregiously false" statements on tax returns. He also declined to retain independent appraisals of the three FLPs, bragging to the Hurford heirs that he had "experience obtaining 50% discounts in settlements on estates with the IRS." I struggled to find any positive comments from the court or support for the Estate's argument in the 80+ page summary. It was a "train wreck" from the start.

However, one last interesting piece of information from this case is that the court offered a list of factors that, if present, will incline them to find that the transfer of property to an FLP was not motivated by a legitimate and significant nontax purpose. Interested in learning what these are? Or, would you like to read my entire 2 ½ page summary of this interesting 80+ page memorandum? Please visit my website (www.mackbusinessappraisals.com), click on the "Court Cases" tab, scroll to the bottom of the page and click on the link to the Estate of Thelma G. Hurford v. Commissioner. If you have trouble accessing the summary on my website, please feel free to email me or call me and I'll be happy to send you a copy of my summary.



Cubs Corner: It has been a relatively busy offseason for the Cubs. Players lost to free agency or traded include key players such as Kerry Wood, Mark DeRosa, Bob Howry, Jason Marquis and Jim Edmonds. New players added include Milton Bradley, Aaron Miles, Kevin Gregg and Joey Gathright. And, there are continuing rumors that they may be adding another starting pitcher (possibly 2006 Cy Young winner Jake Peavy from the Padres) before Spring Training. I'm already itching to get to a Spring Training game and get the 2009 season started!



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About Mack Business Appraisals, LLC

Mack Business Appraisals, LLC is an experienced valuation firm that provides expert business valuation services to businesses across the United States for various purposes including, but not limited to: gift and/or estate tax, merger and acquisition, ESOP's, FASB 141/142, buy-sell agreements, S-corporation election, SBA funding, stock option granting and management planning purposes. Mack Business Appraisals, LLC also has extensive experience in valuing family limited partnerships (FLP's) and limited liability companies (LLC's) for gift and estate tax purposes.

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