

# Valuation Insights

Volume 1 Issue 1

April, 2008

## INSIDE THIS

### ISSUE:

WELCOME 1

IS YOUR CLIENT'S  
BUSINESS THEIR  
RETIREMENT  
PLAN? 1

FARNAM V.  
COMMISSIONER 2

CUBS CORNER 3

## Welcome!

Welcome to the inaugural issue of Valuation Insights, the new quarterly newsletter published by Mack Business Appraisals, LLC. It is our goal that this newsletter will provide attorneys, CPA's, business intermediaries, bankers and other financial advisors with timely information relating to issues surrounding our key areas of expertise which include:

- Gift and Estate Tax Valuations
- Other Tax Related Valuations (e.g. S-corporation election)
- Merger & Acquisition Valuations
- ESOP Formation & Administration Valuations
- Management Planning Valuations (e.g. Buy-Sell Agreements, Stock Options)
- Financial Reporting Valuations (FASB 141 and 142)



Over the next several issues we will address key valuation topics and related areas of interest that impact not only ourselves but other professionals that we work with in these aforementioned areas. It is my plan for this newsletter to change over time to adapt to what our trusted advisors and professionals that we work with really want to read. Accordingly, if you ever have any comments or questions or have any specific requests that you would like our newsletter to address, please feel free to email me at [john@mackbusinessappraisals.com](mailto:john@mackbusinessappraisals.com).

Finally, as we all need a "lighter side" of life, I will also have some fun with each issue. Being a big sports fan (especially the Chicago Cubs), I will provide you with some lighter fare surrounding sports news and other interesting facts. It may be hard to do, but for all you D-Backs fans I may have to also throw you a bone every once in awhile. So sit back, relax and enjoy!!!

## Is Your Client's Business Their Retirement Plan?

Over the years I have been amazed by the fact that very few business owners have ever had a business valuation and most don't have any realistic idea as to the value of their business. Conversely, for the majority of these owners, their business represents their single largest asset for retirement. Isn't there a disconnect here? I think a great service that we can provide to our clients as their trusted advisors is to make sure that our clients understand the benefit of knowing the value of their business and learn ways that they can increase and maximize its value prior to their retirement. A recent online study indicated that with the baby boomer genera-

tion reaching retirement, approximately 70% of the more than 300,000 privately held U.S. businesses with revenues of \$5 million to \$150 million will transfer ownership within the next 10 years. Furthermore, most experts suggest that business owners should start preparing for the transition of their business at least three years prior to sale to help maximize value. Please feel free to contact us if you would like more information on how we can help your clients understand the value of their business as well as help them to plan for and maximize its value upon the sale of the business.



In a recent study by the Alliance of Merger and Acquisition Advisors, it was believed that 7 out of 10 midsize businesses will change hands within the next 10 years and nearly 90% of these business owners have not kept adequate records or documentation and are not prepared to sell.

## Estate of Duane B. Farnam and Estate of Lois L. Farnam v.

### Commissioner, 130 T.C., No. 2, February 4, 2008.

“The Court stated that, in general, in order for an estate to qualify for a QFOBI deduction, the value of the QFOBIs must exceed 50 percent of the total value of the decedent’s adjusted gross estate—the “50 percent liquidity test”.



“I also wonder if it would have made any difference to the Tax Court if the Estate had cried “poverty” and that indicated that they were going to have to sell the business (FGP) to pay the additional taxes if they were ruled against “

**The Facts:** Duane B. Farnam and Lois L. Farnam resided in Otter Tail County, Minnesota, at the time of their deaths in September 2001, and June 2003, respectively. Mr. and Mrs. Farnam owned, along with other members of the Farnam family, and managed Farnam Genuine Parts (FGP). FGP was a Minnesota corporation which operated retail and wholesale automobile parts stores. Duane Farnam operated the business as a sole proprietorship for many years prior to its incorporation in 1981. Beginning in 1981, and each year thereafter, Mr. and Mrs. Farnam, as well as other family members and related entities, made loans to FGP, which were used in FGP’s business operations. FGP issued promissory notes for all funds received. The notes were unsecured and subordinate to claims of FGP’s outside creditors. Prior to 1984, FGP repaid only principal on the loans, however, after 1984, because of new tax laws, FGP made annual payments of principal and interest.

In 1995, Mr. and Mrs. Farnam formed the Duane B. Farnam Limited Partnership (Duane LP) and the Lois L. Farnam Limited Partnership (Lois LP). Decedents were each partners in both limited partnerships and contributed their ownership interests in ten (10) buildings and in several FGP notes. The primary business of each partnership was to own, maintain, and lease buildings to FGP for use as parts stores.

At the time of the Mr. Farnam’s passing in 2001, they each individually owned 50% of the 1,000 outstanding shares of FGP voting common stock and Mark Farnam (decedents’ only son) owned the remaining 99,000 outstanding shares of FGP non-voting common stock. In addition, Mr. Farnam owned a 99% capital interest and Mark Farnam owned a 1% capital interest in Duane LP. At the time of Mrs. Farnam’s passing in 2003, Mrs. Farnam and Mark Farnam each owned 50% of the 1,000 outstanding shares of FGP voting common stock, and Mark Farnam continued to own the 99,000 outstanding shares of FGP non-voting common stock. Mrs. Farnam also owned a 92.72% capital interest in Lois LP, and Mark Farnam, his wife and children owned the remaining 7.28% capital interest in Lois LP.

Estate tax returns were filed for both estates on which were claimed qualified family-owned business interest (QFOBI) deductions of \$625,000 and \$675,000 respectively.

**The Arguments:** The argument for consideration was whether the FGP notes should be included in the calculation of the QFOBI 50-percent liquidity test of section 2057 (b) (1) (C). If the FGP notes are to be treated as QFOBI’s, then the adjusted values of the QFOBI’s decedents own will constitute approximately 80% of Mr. Farnam’s and 56% of Mrs. Farnam’s estates. However, if the FGP notes are not treated as QFOBI’s, then the adjusted values only constitute 44% and 24%, respectively.

The Estate argued that for purposes of meeting the 50-percent liquidity test of section 2057 (b) (1) (C), an “interest” in a family corporation or partnership may include not only equity ownership, but also loan interests. Respondent argued that an “interest” in a family corporation or partnership does not include a loan interest in the family corporation but instead only represents an equity interest.

The Court's discussion focused on the statutory interpretation of the language of section 2057 (e) (1) (B), namely, "an interest in an entity" carrying on a trade or business. The Court indicated that their function was to apply the statute according to its terms if the language of the statute is plain and unambiguous. However, if the statute is ambiguous, the Court then looks to the statute's legislative history and other authorities for assistance in determining legislative intent.

The Court stated that, in general, in order for an estate to qualify for a QFOBI deduction, the value of the QFOBIs must exceed 50 percent of the total value of the decedent's adjusted gross estate—the "50 percent liquidity test". In addition, it is expressly stated in subparagraph (A) that a QFOBI with regard to a sole proprietorship means only an equity interest therein (i.e. "as a proprietor"). Under section (B) relating to family-owned corporations and partnerships, no such express equity limitation on the definition of an interest in a family-owned entity is stated, and reference is made, in the flush language, only to "an interest in" a family-owned entity.



The Estate argued that the absence of an express limitation of the word "interest" in section 2057 (e) (1) (B) indicates that no such limitation was intended and therefore "loan" interests should be taken into account. The Estate also noted that section 2057 makes a number of references to "any" interest in a quali-

fied family-owned business, suggesting that the reference is not to be limited to just an "equity" interest. Furthermore, the Estate argued that the general purposes of section 2057 support a broader interpretation of an interest which may qualify as a QFOBI. These general purposes are: (i) to reduce estate taxes for qualified family-owned businesses, (ii) to protect and preserve family farms and other family-owned enterprises, and (iii) to minimize the liquidation of such enterprises in order to pay estate taxes. The Estate argued that these purposes may be compromised if estates owning family businesses funded with equity qualified for QFOBI deductions and estates owning similar family business funded in part with shareholder loans did not.

Respondent argued that estates holding loan interests would not have the same difficulties paying estate taxes as estates holding only equity interests in family businesses because loan interests could be sold to un-related investors to obtain funds without affecting the ownership of the company.

**The Findings:** The Court's determination was based on the proximity of the language "interest in an entity" in section 2057 (e) (1) (b) as to the explicit equity ownership language of section 2057 (e) (1) (B) (ii).

The court thought it would not be logical to separate the ownership requirements of the section from the language immediately preceding it. The Court concluded that the definition of an "interest in an entity", for purposes of the QFOBI deduction, is limited to the equity ownership interests, and therefore upheld the respondent's argument that the FGP loan interests held by Mr. and Mrs. Farnam could not be treated as QFOBIs for the purposes of section 2057 and thus were not allowable deductions.

**Parting Thoughts:** I found this to be a very interesting case and was surprised that this ambiguity had not already been addressed through prior case law. I also wonder if it would have made any difference to the Tax Court if the Estate had cried "poverty" and that indicated that they were going to have to sell the business (FGP) to pay the additional taxes if they were ruled against.



**Cubs Corner:** The Cubs Wrigley Field naming rights are for sale and may fetch as much as \$400 million. However, did you know that Wrigley Field is the third name for the stadium? It was initially called Weeghman Park when built in 1914, then changed to Cubs Park in 1920 before being changed again to Wrigley Field in 1926. Personally, I don't care what its called next, it'll always be Wrigley Field to me.



Visit [www.mackbusinessappraisals.com](http://www.mackbusinessappraisals.com)

E-mail: [john@mackbusinessappraisals.com](mailto:john@mackbusinessappraisals.com)

Fax: 623-476-5405

Phone: 623-340-6770

Peoria, Arizona 85383

2695 N 90th Lane



## 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.

John G. Mack, ASA, CBA, is the managing member of Mack Business Appraisals, LLC. Mr. Mack is a 1993 graduate of the University of Iowa with a Bachelor's degree in Finance from the College of Business Administration. Mr. Mack is an accredited member of the American Society of Appraisers (ASA), Business Valuation Discipline, and has also attained the Certified Business Appraiser (CBA) designation as offered by the Institute of Business Appraisers, Inc.



Copyright © 2007 Institute of Business Appraisers