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Valuation Discounts

Introduction

Generally, when businesses are valued, the owner likes to see the highest value possible for the business. After all, it is human nature to desire the most wealth possible. Many times, valuations will be prepared to determine what price potential exists if the business is sold. Even when trying to obtain an amount for a spouse's business during a divorce proceeding, a valuation will be completed with a view toward the highest value possible. Other situations exist where the client desires a low value; such situations include estate planning, divorce when the client will be paying out a sum, and when a potential buyer desires to purchase a business.

Legitimate avenues do exist however, to reduce the value of any given business when appropriate. Discounts determined for lack of control and lack of marketability are legitimate and even common in valuations. In addition, as of late, discounts taken for a built-in gains tax potential are becoming increasingly common as more case support develops for the use of them.

Three Key Discounts:

(1) People generally prefer to have controlling

power as opposed to being controlled. The **lack of control** discount or minority ownership discount in closely-held and small companies is given to reflect the detrimental effect of not having control of a business. While a minority interest in a publicly traded company is not subject to a lack of control discount, in small companies, lack of control means the minority owner is subject to the whim of majority shareholders. Such detrimental decisions to minority shareholders can include: determination of management compensation, declaration of dividends and disbursements, setting the course of the business, and decisions to liquidate or sell business interests. Lack of control discounts can range from 35 to 50 percent, and even higher in some cases when compared to publicly traded stocks. Readers should be aware that the state of Florida has recently passed a law making the minority discount illegal whenever a company that has ten or fewer owners is valued.

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A CASE STUDY

The Eighth Circuit Court of Appeals has held that property transferred to a family limited partnership (FLP) is includible in a husband and wife's gross estate because they retained the right to income from the property that was transferred. In this case, the couple transferred some of their assets to a revocable living trust. They also transferred other assets to a FLP in exchange for a 98% limited partnership interest. The trust then transferred some assets to the FLP in exchange for a 2% general partnership interest. The couple then gifted their limited partnership interests to four irrevocable

trusts for their children. The Appellate Court affirmed the decision of the Tax Court in holding that the transferred assets were includible in the couple's estate because they retained an economic interest in the transferred assets and there was not adequate consideration for the transfer. The court found a great deal of evidence to support its conclusion, which included the fact that the FLP made payments to the couple's trust for their expenses and that the husband approved the creation of the FLP without any

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(2) The **lack of marketability** discount applies to many small businesses as well. Owners prefer to have assets that are more liquid as opposed to less liquid. It is with this preference that those businesses that can be bought and sold quickly are worth more. Businesses that are hard to liquidate or are generally unmarketable are worth less than publicly traded companies. Because of this lack of marketability, certain businesses are given a discount to reflect the detriment of the ability to sell the company. Lack of marketability discounts can range in the area of 20 to 50 percent when compared to their publicly traded counterparts.

(3) As of late, discounts for **built-in gains tax** are gaining more and more support. When C corporations are converted from taxable entities into flow-through entities, such as S corporations, LLC's and the like, the potential for a tax liability known as "built-in gains" appears. Because of this potential, the company must plan and maneuver carefully around built-in gains issues. Nonetheless, from time to time, decisions are made on business bases that demand that built-in gains be recognized and taxes become due to the government. Many businesses, including businesses with deceased owners, run the risk of paying built-in gains tax. As such, taxpayers have successfully argued that such potential liability can be deducted from the value of a business under the theory that an investor, similarly situated, could purchase similar securities in a business without the built-in gains tax potential. It is because investors can invest elsewhere in order to avoid tax losses, theoretically, that the company with the built-in gain tax event potential is worth less than a company that does not have potential for a huge tax loss.

Conclusion

Some confusion results between the two types of discounts noted above when analysts arrive at discounts for control and marketability. Minority ownership interest discounts relate to the control the subject has in relation to the business. Marketability, on the other hand, deals with the potential to liquidate the company and how quickly and easily the company can be reduced to cash.

Discounts based on control and marketability have been around since the beginning of valuations. The built-in gains tax liability discount is new, and it has more estate tax implications, as well as gift tax consequences than other discounts. The importance behind built-in gains tax potential, in recent years, is substantial because so many C corporations are now converting to flow-through entities in order to take advantage of single level taxation. Knowledge and use of the built-in gains discount is critical for valuations.



THE IMPORTANCE OF A STRONG BALANCE SHEET

Most M&A experts agree that the ultimate transaction value of any profitable, on-going business is largely determined/ influenced by its cash flow, which is most frequently expressed as its adjusted, or normalized, earnings before interest, taxes, depreciation and amortization (EBITDA). If that's the case, why should we be at all concerned about the strength of the company's balance sheet?

In point of fact, the role of the company's balance sheet in the M&A valuation process is not well understood – even by most M&A professionals. Recognizing that in almost all cases the buyer will need to

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negotiation or input from the limited partners.

Editor's Comment: This case illustrates some of the flaws of family limited partnerships. One of the key factors considered by the court in their holding was the fact that the estate failed to show that the FLP was formed to protect the family from commercial and personal liability or liability from divorce. While a FLP may be appropriate for protection in those particular circumstances, it is not always the most beneficial tool in estate planning. This case demonstrates how important it is to consult with experienced professionals when putting together an estate plan. The professionals at The Center have the experience needed to determine the right estate plan for you.

Points of Interest

- **Generally, when businesses are valued, the owner likes to see the highest value possible for the business.**
- **While a minority interest in a publically traded company is not subject to a lack of control discount, in small companies, lack of control means the minority owner is subject to the whim of majority shareholders.**
- **Taxpayers have successfully argued that potential built-in gains tax liability can be deducted from the value of a business.**

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re-engineer the company's debt in order to finance the acquisition, most M&A advisors spend little time analyzing the seller's balance sheet.

In reality, the strength of the company's balance sheet, particularly as it relates to the collateral value of the company's assets, plays an important role in determining just how much bank debt the business will support, which in turn affects how much cash equity the buyer will have to invest to finance a particular purchase price. Since bank debt typically has a much, much lower return expectation (interest rate) than equity, a company with a strong balance sheet can typically command a much higher purchase price, and still meet the buyer's expectations for the return on his equity investment.

It is principally for this reason that manufacturing businesses typically sell for a higher multiple of cash flow than a distribution company, which in turn sell for a higher multiple than service companies.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free consultation with us, have them contact me, or any of the M&A professionals at www.bradwaygroup.com

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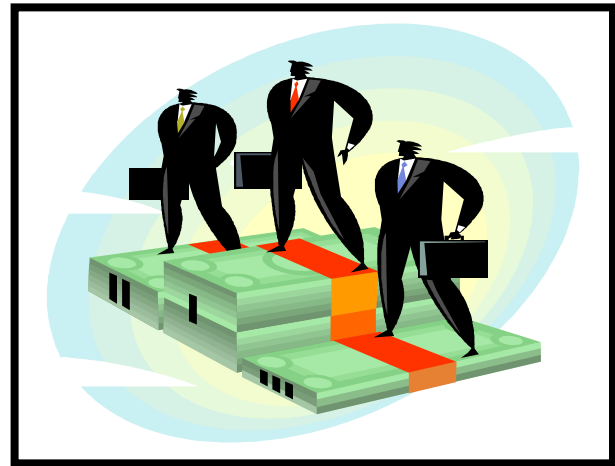
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Frequently Asked Questions...



Q: Why are valuation discounts for minority shareholder interests illegal in some states?

A: In most states, laws exist for the purpose of protecting minority shareholders against the majority interest shareholders. A sweep of corporate case law plainly reveals that many situations have occurred where the minority shareholder has been taken advantage of by the majority shareholders. State laws, including those not allowing minority shareholder discounts, have been written to help prevent squeeze outs, freeze outs, and shake outs. When valuing a company in these states, it is important for the appraiser to be aware of the laws and plan and create the valuation accordingly.

Q: When determining a value for a company, is it permissible to use a multiple instead of a long, formal valuation?

A: Merely using a multiple is not a practice that is allowed by the IRS or other valuation professionals. An arbitrary multiple (such as 3, 4 or even 7) used against an arbitrary number such as tax profits or financial profits will yield another arbitrary and useless number. To get a good, solid value, a business owner must rely on trained professionals to get a value that is acceptable and defensible.

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