KTS VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC. 2008-3

KLARIS, THOMSON & SCHROEDER, INC. ("KTS") Celebrates 15 Successful Years in Business!

It is hard to believe that it has been over 15 years since Klaris, Thomson & Schroeder, Inc. ("KTS") was formed! KTS has grown considerably from our original five employees and two offices!

Thanks to our dedicated team of employees and valued clients throughout the country and overseas, who have supported us over the last 15 years, we are able to celebrate this momentous milestone today.

We look forward to delivering the highest quality service to our clients and future clients for the next 15 years.

HAPPY HOLIDAYS FROM ALL OF US AT
KLARIS, THOMSON & SCHROEDER, INC.

Pictured from Left to Right:
Ray Klaris, John Thomson, Gary Schroeder

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Estate of Lillie Rosen

By John A. Thomson, ASA, MAI

Background: Decedent, Lillie Rosen, died on July 2000 at the age of 92. The decedent had a son, daughter, and a son-in-law. The decedent's son-in-law had practiced as an attorney for more than 50 years, and regularly attended seminars on estate planning and the federal estate tax. Mr. Stuart Feldman ("Feldman") was the decedent's estate planning attorney. The Family Limited Partnership was funded primarily with marketable securities and was established July 31, 1996.

The tax court concluded that the decedent retained the possession or enjoyment of, or the right to the income from property transferred to the Lillie Rosen Family Limited Partnership ("LRFLP") with the result that the property is included in her gross estate under Section 2036.

What is Section 2036?

The general rule is that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona-fide sale for adequate and full consideration in money or money's worth),

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Estate of Lillie Rosen

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by trust or otherwise which the decedent has retained for the decedent's life or for any period not ascertainable without reference to the decedent's death or for any period which does not in fact end before the decedent's death - the possession or enjoyment of, or the right to income from the property.

The court went on to say the following, "on the basis of the credible evidence in the record, we conclude that the transfer of the decedent's assets was not a bona-fide sale within the measuring of Section 2036 (a) (i). We find that the overwhelming reason for forming the LRFLP was to avoid federal estate and gift taxes and that neither the decedent nor her children had any legitimate and significant non-tax reasons for that formation.

Six summary concerns why Section 2036 applied in this case.

1. The LRFLP was not engaged in a valid functionary business operation, and the LRFLP served no legitimate or significant purpose; it operated simply as a vehicle for changing the form in which the decedent held her beneficial interest in the transferred assets (Trust to Family Limited Partnership).
2. The partners of the LRFLP agreement, (which was signed on July 31, 1996) were less than timely with their initial contribution. The decedent did not make her initial contribution until October 11, 1996 and the decedent's children did not make their initial contributions until October 24 and 30, 1996. The decedent's children were also deminimis in relation to the assets contributed by the decedent.
3. The decedent, acting through her daughter (her attorney-in-fact and co-trustee of the trust) transferred substantially all of the decedent's assets, including all of her investment assets, to the LRFLP. The management of the transferred assets was the same both before and after the transfer, and no meaningful change occurred in the decedent's relationship to her assets after the transfer.
4. After the transfer of the assets to the LRFLP, the decedent was unable to meet her financial obligations without using funds of the LRFLP.
5. The assets that were contributed to the LRFLP consisted solely of marketable securities and cash.
6. The decedent's age and health were issues. In 1994, two years before the LRFLP agreement was signed, the decedent was suffering from dementia and Alzheimer's disease. The fact that the decedent was 88 years old and in failing health strongly supported the finding that the transfer of the assets was purely for the purpose of avoiding federal estate and gift taxes.

In conclusion, if you are going to establish a family limited partnership, you need to do it carefully and professionally and there better be a good business purpose other than tax avoidance. Also, after the family limited partnership is formed it should be operated according to the partnership agreement. The i's need to be dotted and the t's need to be crossed.

Postscript (Valuation)

As a result of the IRS victory, in this specific case, based on Section 2036, there was no discussion of the valuation issues. The partnership discounts go away (are disregarded) under Section 2036. There were five dates of value, four for gift tax and one for estate tax. Klaris, Thomson & Schroeder, Inc. ("KTS") did testify for the IRS. A point of interest is that the five overall discounts opined by the IRS's expert and the taxpayer's expert were very close (for example 30 vs. 33), yet both experts still were required to testify. The taxpayer was unwilling to stipulate to value and just argue the 2036 issue. ❒

The Business Appraiser's Role in IRC Section 108(b) Forgiveness of Debt Valuation Assignments

By Lou DiSilvestro, ASA

Gone are the days of easy money, when credit history, income, and the likelihood of repayment received scant attention. The lax lending standards which had fueled the U.S. economy in past years have given way to a credit crunch, in which borrowing has become more difficult. Meanwhile, many highly leveraged transactions consummated prior to the onset of the current credit crunch have come back to haunt investors and creditors alike. As these deals have turned into disasters, creditors increasingly find themselves mired in Chapter 11 proceedings, investors have discovered that their investments have become worthless, and many debt-laden businesses are being put on the auction block. As an alternative to the above scenario, companies and their creditors can opt for financial restructuring. Creditors are more willing to forgive a portion of the outstanding debt if the "new" business is made more viable, as this allows them to potentially preserve a large portion of their invested funds.

While the recently implemented Mortgage Forgiveness Debt Relief Act of 2007 allows homeowners to exclude certain cancelled debt on their principal residences from income, forgiveness of debt is not viewed as a neutral transaction by the Internal Revenue Service in other situations. In such other situations, a dollar of forgiven debt is a dollar of taxable gain, unless certain pro-

The Business Appraiser's Role in IRC Section 108(b) Forgiveness of Debt Valuation Assignments

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visions are met. For solvent companies, there is no generic relief from recognition of taxable gain on debt restructuring. However, Section 108(b) of the Internal Revenue Code provides several benefits for "insolvent" and bankrupt corporations, including partial or full exclusion of cancellation of indebtedness (COD) income from taxable income. The exclusion is applicable to an insolvent company only to the extent of its insolvency.

A company not operating under Chapter 11 of the U.S. Bankruptcy Code is considered insolvent if its liabilities exceed the fair market value of its assets **immediately before the cancellation of the indebtedness.** The amount that may be excluded from income is the amount by which the liabilities exceed the fair market value of the assets. Therefore, the assets of the company must be valued immediately before the debt discharge since COD income is avoided only to the extent of the insolvency at that time. The valuation should include certain off-balance sheet assets, including intangible assets such as goodwill (see *Conestoga Transp. Co. v Commissioner,* 17 T.C. 506 (1951), acq., 1952-1 C.B. 2; this was also the position taken by the IRS in *J.A. Maurer, Inc. v. Commissioner,* 30 T.C. 1273, 1292 (1958), acq., 1959-1 C.B. 4.).

In addition to the above need for valuation services, many times stock is issued in lieu of the cancellation of debt, creating the need for a valuation of the issued stock after the cancellation of debt.

The business appraiser is usually the project manager of Section 108 valuation assignments. It is his or her responsibility to meet with the attorneys and accountants to determine the specific valuation needs. In most cases, the underlying assets of the company need to be appraised. This involves the use of real estate and machinery and equipment appraisers. One of the business appraiser's duties is to determine the relevant values (i.e. market value, orderly liquidation value, etc.) that are needed from the real estate and equipment appraisers. Usually in a Section 108 assignment the underlying assets should be appraised at both market value and orderly liquidation value.

Once the underlying fixed assets have been identified and appraised, the business appraiser identifies and appraises intangible assets such as patents, trademarks, customer lists, etc. The valuation of individual intangible assets of the company, however, does not include the valuation of any goodwill or going concern value that may exist.

To determine the value (if any) of goodwill or going concern, the business appraiser must first value the invested capital of the company. Invested capital is defined as shareholders' equity plus interest-bearing debt, and it is sometimes referred to as the business enterprise value. Invested capital is normally valued using a multiple of invested capital to earnings before interest expense, taxes and depreciation and amortization expense (EBITDA) or a multiple of invested capital to earnings before interest and taxes (EBIT) for the market approach. With respect to the income approach, a discounted debt-free cash flow method is commonly used.

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Once the invested capital value is derived, the value of the company's total assets can be determined by adding the non-interest bearing current liabilities to the invested capital value. The resulting value of the total assets is then checked against the sum of the market values of the individual assets. If the value of the total assets is larger than the sum of the market values of the individual assets, then the residual value is determined to be the value of goodwill and going concern. If the total value of the assets is less than the sum of the individual asset values, then it is concluded that there is no goodwill or going concern, and the individual asset values need to be adjusted downward for economic obsolescence.

If the value of the total assets is less than the sum of the orderly liquidation values of the individual assets, then the sum of the individual assets' orderly liquidation values is concluded to be the appropriate value of the total assets. This value "floor" is based upon the fact that a prudent investor could realize the liquidation value of the individual assets by selling them individually.

Once the correct value of the total assets is determined, it is compared to the total liabilities of the company prior to the cancellation of debt. If the liabilities exceed the market value of the total assets, the company is considered to be insolvent for Section 108 purposes. In these cases, debt can be reduced by the amount that total liabilities exceed the market value of the assets, without incurring an income tax liability.

Many times in Section 108 assignments the appraiser will be asked to perform a preliminary study to determine the amount of debt that could be forgiven without incurring a tax liability. In these cases, a final appraisal needs to be done just prior to the financial structuring due to the changing nature of liabilities and values.

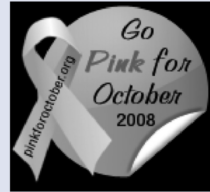
The final valuation issue in many Section 108 transactions involves the determination of the value of the stock to be issued in lieu of the debt cancelled. As the market value of this stock can also trigger tax consequences its valuation can be very important. This stock can be preferred or common, and it should be valued under the premise that the cancellation of debt has occurred. All projections and valuation multiples should take the debt cancellation into consideration, and the date of value should be immediately after the cancellation of debt. There are no other special rules to valuing the issued stock except that potential dilution must be considered.

Section 108 valuation assignments can be complex. The business valuation appraiser, as project manager, should anticipate numerous meetings before and during the assignment with attorneys, accountants, and with the fixed asset appraisers. Various scenarios and changing assumptions can make these assignments challenging and trying, but successful completion of the assignment is rewarding. Additional personal satisfaction results when a company that was struggling to survive keeps its assets and personnel employed and gets on the road to recovery. ❒

NEWS & NOTES

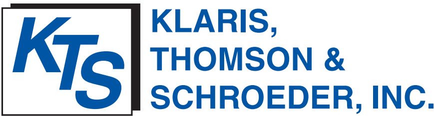
Klaris, Thomson & Schroeder, Inc. welcomes the submission of related articles from our readers.

Please contact Anita Thomson at 877-587-7008.



Klaris, Thomson & Schroeder, Inc. is celebrating 15 years in business: 1993 - 2008!

KLARIS, THOMSON & SCHROEDER, INC. DONATED IN OCTOBER A PORTION OF OUR BILLING TO FINDING A CURE TO FIGHT AGAINST BREAST CANCER.



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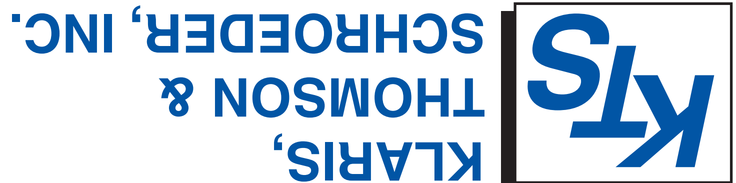
For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to ktsinc@verizon.net.



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Keeping together is progress.
Working together is success."*

– Henry Ford

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