

Perspectives - On Business

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Business Valuation Variations

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When Is a Rose Not a Rose?

Mr. True owned businesses that had, by his principle, no owners other than family members. His buy-sell agreements were to be activated by the spouse or children not working in the business, an attempt to transfer their interest in the business, their death, or disability.

The children were allowed to purchase interest in the company in 1971 and then Mr. and Mrs. True gifted additional interests to them in 1973.

When the daughter wanted to set off on her own, he purchased her shares of the business according to their buy-sell agreement. It specified that the value of the shares was the tax book value. One might think that would be proof enough of a valid business agreement. The IRS challenged that price, however, since the value was below liquidation value.

It also didn't take earnings into account. They assessed gift taxes on the transfers. However, the Court upheld the buy-sell value and Mr. True continued to make gifts of stock to his children using book value.

Mr. True died unexpectedly in 1994 and the estate transferred the interests in the True Companies according to the buy-sell agreement, at tax book value. The IRS protested. They challenged the values used in the 1971 and 1973 transactions, as well as the values used by the estate, claiming neither were fair market values.

To emphasize their position, the IRS assessed penalties for under valuation. Tax deficiencies were calculated at \$75 million and the penalties were over \$30 million. You might imagine the matter went to court.

The Tax Court rejected the family's argument that the price was a fair and valid value for the business. They called it a "substitute for testamentary disposition" based upon three things: 1) failure to prove the original price was adequate at the time the parties entered into the agreement, 2) that it was not an "arm's length transaction" and 3) that it was not fair market value.

The written opinion, documented in 336 pages, threw out 23 years of consistent family valuation methods, and arrived at its own value. The resulting assessment was \$18.2 million in tax and penalties on \$3.1 million of under valuation. The Court of Appeals has now upheld the Tax Court.

The True buy-sell agreement got 3 out of 4 provisions right. It was the fourth one that did them in. To constitute a valid buy sell agreement that will control the company value for estate tax purposes, the agreement should have provided evidence that it was entered into for bona fide business reasons and is not a testamentary substitute intended to pass on the decedent's interests for less than full and adequate consideration.

Sandra Heusinkveld
sandra@fpperspectives.com

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Future Finances' Market Update

By Max Larsen

Monday, January 24, 2004

A few years ago, it used to be popular to give people Rorschach tests, in which you were given a few inkblots and asked to tell what they reminded you of. This weekend as I was reviewing the market, I was reminded of that as I reviewed the action of many market indices. Depending on which "ink blot" I looked at, my "market opinion" could have been swayed to see almost anything.

It was the third straight weekly decline for the stock market. In fact, this is the first time since 1977 that the Dow and S&P 500 have started the year with three down weeks. (*The Wall Street Journal*). Concerns over a drop in consumer sentiment and an increase in oil prices (yet again) were the two main culprits.

The surprise was we ended the week down, and we are now in the 4th quarter earnings announcement season - and they are looking good. With over 25% of the S&P 500 companies having reported, with over 80% of reporting in line with or about the average Wall Street forecast. Enough companies have beaten estimates, that the aggregate forecast for operating earnings was raised to +17% from +15% by *First Call*.

This is actually quite typical for earnings season. Less than 20% of companies miss forecasts, and over 60% surpass expectations. The earnings results overall tend to end up about 3% above expectations. Yet, if you read the business section of most newspapers you will always hear about the "ones who didn't make it". Once again, bad news sells - even if it really isn't news. Go figure...

Other positive news was the release Friday of the Conference Board's composite index of leading indicators, a closely watched gauge of future U.S. economic growth. As the Wall Street Journal so aptly put it: "Key Indicators of Growth Rose Again in December". Yep, the index, which is designed to signal the direction of the economy, in three to six months, looked good. It even caused Ken Goldstein, an economist at the Conference Board to proclaim: "The leading index is now

flashing green. That signals while we might hit some choppiness in early 2005, by spring we will have decent or better overall economic growth."

So, the stock markets are going down but the news is generally good. I believe that many are still looking at the big picture and are worried about high valuation, the U.S. Dollar, the huge trade deficit, etc. and just don't believe that high corporate earnings can carry the day (or will continue).

Still, in the short run I see the selling pressure that has been punishing stocks in the first part of January subsiding this week as fourth quarter earnings announcements begin to flood the stock market. It may not rebound big since many are waiting for the Iraq election and the meeting of the Federal Reserve on February 1st and 2nd. If all goes well with the election and the Fed doesn't have any spooky inflation comments, the stock market could see a temporary relief rally. Let's hope so.

That is all for today my friends. It's brutally cold in Columbus again and I have to go put a few more lumps of coal on the fire.

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Sandra Heusinkveld, President
Financial Planning Perspectives, LLC
1333 Clubview Blvd. North
Columbus, OH 43235
614-785-0156 tele
614-485-0176 fax
sandra@fpperspectives.com
www.fpperspectives.com

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