

VALUE ADDEDTM

Business Valuations • Litigation Support • Mergers & Acquisitions

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BUY-SELL AGREEMENTS

Buy-sell agreements are designed to provide for the orderly transfer of ownership and control of businesses due to the planned retirement or untimely death of a participating shareholder, as well as to insure that the shares of otherwise departing shareholders remain in "friendly" hands. Good buy-sell agreements provide for a realistic method of valuation as well as a means of funding. The fairly typical "right of first refusal" agreement, which provides for neither valuation nor funding does not fall into the same category as a buy-sell agreement.

This commentary briefly addresses the valuation issue for buy-sell agreements. Many buy-sell agreements use book value as a basis of valuation; others use some formula or multiple of earnings; still others call for periodic updates by the shareholders to keep valuation current. Sometimes the shareholders never agree upon a formula or valuation rationale, and the agreements are never completed.

Most of the buy-sell agreements this firm has seen have two things in common: 1) they generally assume (implicitly) that the "other guy" is going to die first, and thus tend to shift value to the remaining shareholders; and 2) the mandated periodic valuations by shareholders (a common valuation mechanism) are often not kept current, particularly when no specific funding mechanism is provided for in the agreement. The agreements are overlooked or just ignored, and shareholders may develop conflicting views on valuation, laying the seeds for future problems. Fortunately, most of these problems can be avoided by careful drafting by experienced counsel, and addressing of the critical issues of valuation and funding on the front end.

There are several potential valuation problems inherent in buy-sell agreements with numerous attorneys. One method of solving the valuation issue calls for the shareholders to agree to value as determined by a previously selected independent appraisal firm in the event that the valuation requirement is triggered under the agreement's terms.

Independent appraisal services are increasingly becoming the buy-sell valuation mechanism of choice. Once shareholders agree upon the qualifications and independence of an appraisal firm, all know that valuation under the agreement will be objective and independent of any individual shareholder's interests (and therefore, fair to all shareholders).

Please write or call for more in-depth analysis of buy-sell agreements and related valuation issues.

NEW RULES GOVERNING ESTATE TAX FREEZE RECAPITALIZATIONS

THE REPEAL OF IRS SECTION 2036(c)

Business owners and their financial advisors are taking a new look at the estate freeze strategy for minimizing eventual estate tax liability. In 1987, Congress essentially prohibited the popular estate freeze recapitalization through legislation codified in IRC Section 2036(c). Today, the estate freeze is again viable under the law, but under a new set of rules that require a more accurate gift tax valuation of lifetime transfers to heirs.

Previously, a "freeze" was an estate tax planning tool that enabled a family business owner or owners to

(Continued on Page 2)

IN THIS ISSUE

Buy-Sell Agreements	1
New Rules Governing Estate Tax Freeze Recapitalizations: The Repeal of Section 2036(c)	1
Minority Versus Controlling Interest Valuations-Part II	3
Christmas is Just Around The Corner	4

pass on to heirs any future appreciation in the value of the business, while retaining a preferred stock (or other interest) and voting control. At the date of the freeze, most of the business' value was attributed to the preferred stock or other frozen ownership interest, and the gift of the owner's lower value common stock to the heirs created little or no gift tax liability.

At the date of death, the frozen equity interest went to the estate at a value determined at the time of the freeze transaction. On the other hand, any growth in value of the business since the date of recapitalization would belong to the common shares, or other unfrozen interests, in the hands of heirs and be excluded from the taxable estate of the decedent.

The IRS and Congress considered the freeze an abusive tax avoidance technique. Old Code Section 2036(c) removed any incentive for an owner of 10 percent or more of a business to transfer to an heir a "disproportionate" share of future appreciation, while retaining an interest in the business. At death, a transferred interest (say common stock) was required by 2036(c) to be reinstated to the taxable estate as though a transfer had never occurred.

Congress repealed 2036(c) in the Revenue Reconciliation Act of 1990 and replaced it with new IRC Sections 2701 through 2704. The rules might be new, but the theme is familiar - Congress dislikes deferrals of taxable events. Through "special valuation rules", the new law focuses on today's gift tax valuation of business interests transferred to heirs, instead of tomorrow's estate tax valuation. In general, under the new rules, if a business owner transfers an interest in his business to his heirs and retains an interest in the business, then the retained interest

is either deemed to have zero value or is subject to special valuation rules that, in many cases, will ultimately assign considerable gift tax value to the transferred interest. The transferor will often pay gift taxes today for the right to keep future appreciation out of his taxable estate. Today's gift tax could be considerably less than the present value of an unfrozen estate tax liability, especially if the value of the company is fast appreciating.

Congress reinstated the freeze technique, but made the rules quite complex. Some of the new valuation rules include:

- 1) Non-dividend-paying preferred stock retained by the older generation is generally valued at zero. Exceptions apply when market quotes are available, the transferor retains the same class of stock as he transfers, the transferred and retained interests have proportionally the same rights (other than voting), or certain nonlapsing conversion rights are retained.
- 2) Cumulative preferred stock can have positive value in the freeze if its dividend is a fixed rate or is pegged to a floating market rate and it confers liquidation, put, call or conversion rights. Of course, the preferred stock should offer a fair risk-adjusted return to its holder.
- 3) Valuation of cumulative preferred stock is determined at the lowest value resulting from the exercise of any rights attached to it. For example, cumulative preferred stock having a redemption right (put) after a period of years would be valued at the present value of the dividend stream to the date of redemption plus the present value of the redemp-

tion price or, if lower, the present value of the dividend stream in perpetuity.

- 4) The non-payment of cumulative preferred dividends can result in additional gift tax liability or an increase to the taxable estate of the preferred stockholder. Appraisers will want to study the company's ability to pay dividends (free cash flow). Many family businesses are accustomed to plowing back earnings in order to grow, so business owners might have to seek alternative means of financing operations.
- 5) "Junior equity" such as common stock that is gifted may be valued at no less than 10 percent of the total equity value of the company, including indebtedness owed to the transferor and certain family members.

Most importantly, legal advisors and valuation experts need to carefully document and disclose freeze transactions. Along with all the complexity, the new rules say that the statute of limitations will not run on the IRS' right to assess additional gift tax, unless the transferor's gift tax return "adequately discloses" estate freeze transfers.

SPEAKERS' BUREAU

This firm often participates in local and national speaking engagements, which include group seminars and speeches for attorneys, CPAs, CEOs, and other financial advisory professionals interested in topics relating to Business Valuation. Please call for further information or if you would like to discuss a specific speaking engagement.

MINORITY VERSUS CONTROLLING INTEREST VALUATIONS - PART II

The December issue of VALUE ADDED™ contained Part I of this article and provided an overview of issues related to valuing controlling versus minority interests in closely-held businesses. It highlighted the importance of having an understanding of the valuation basis (minority versus control) and provided a conceptual design for valuation relationships. Part II focuses on the key terms in the chart (see inset) and provides a clearer understanding of the important sources of valuation data which are used in arriving at valuation conclusions. Three key terms are used in the chart: 1) Control value; 2) "As if" freely tradeable minority interest value; and, 3) Non-marketable minority interest value.

The Control Value represents the value of the enterprise as a whole. Per Part I, the controlling interest valuation should encompass the rights, risks and rewards of having controlling power in the business.

The "As if" freely tradeable minority interest value represents the value of a minority interest which is freely tradeable in the marketplace. Stated another way, the valuation does not include any of the valuation elements associated with control, yet the conclusion is not penalized by the absence of liquidity inherent in shares which are not traded in the public markets.

The non-marketable minority interest value considers the lower liquidity or marketability which is almost always present in closely held securities. Reduced levels of liquidity can be due to financial issues, absence of registration, absence of contractual agreements to require purchase/sale of the stock, or other factors. Taken as a whole, however, the illiquidity of closely held shares represents one of the

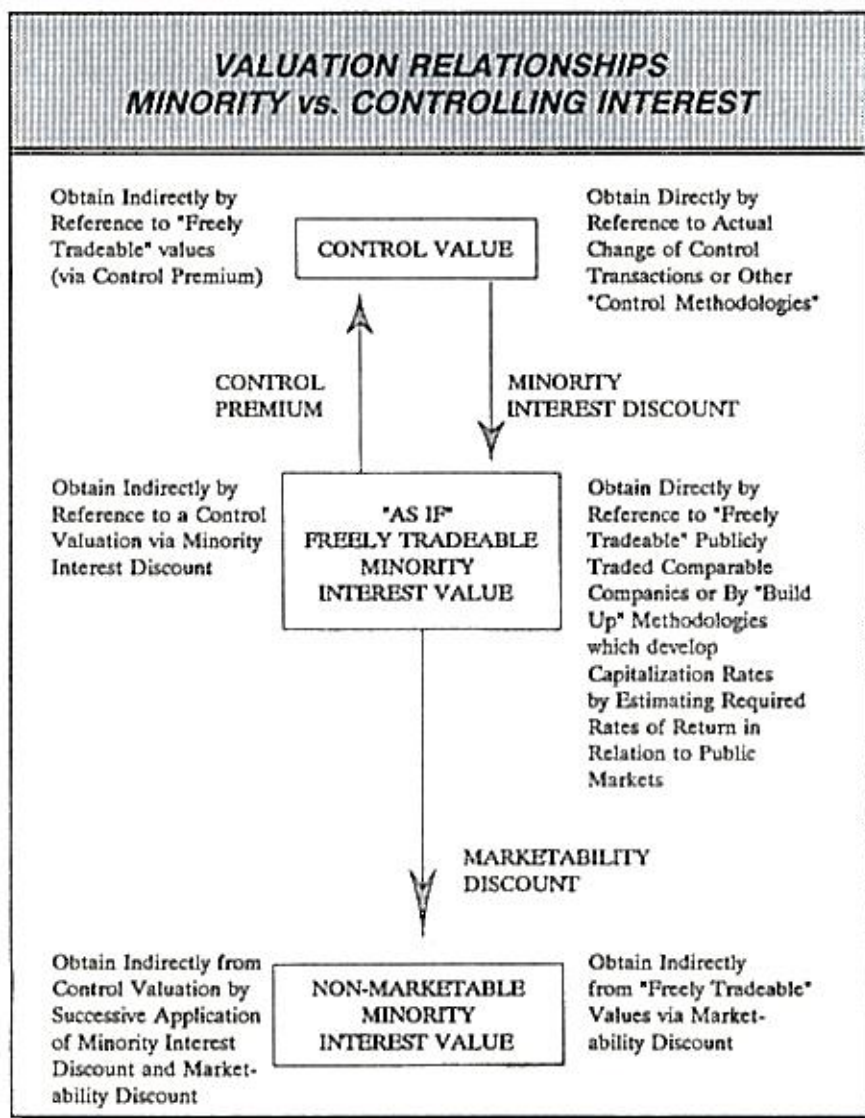
primary reasons their value is generally below that of a freely tradeable security, even if all other factors are similar.

Given the structure outlined above and in the chart, what are the more important valuation issues? For one, most valuations are based in some manner upon a capitalization of net income (or a proxy such as pre-tax income or cash flow). The key questions then become what is the appropriate capitalization factor (i.e., earnings multiple) and to what earnings stream is it applied?

A capitalization factor for an "as if" freely tradeable minority interest can be drawn from the publicly traded companies or from a build-up method. Developing a factor from the public markets generally involves the identification of public

companies which are in a similar line of business and the calculation of an average, median, or other type of composite earnings multiple from the group. A word of caution is appropriate here. The simple application of the public group rate to the subject company can lead to serious errors unless there is a thorough comparison of risk, growth rates, and profit margins between the group and the company being valued.

(Continued on Page 4)



A second source of a capitalization rate is a build up method. Several versions are commonly used which rely upon financial markets theory. In essence the more refined approaches seek to build upon the required rates of return in the market for small publicly traded stocks (including a risk free rate of return as well as a small stock premium) by making adjustments for risk, growth and other fundamentals.

The second major question is to identify the earnings stream to be capitalized. As discussed in the prior article, the appropriateness of adjustments to the earnings stream will vary with the basis of the valuation. The application of a minority interest capitalization factor to a controlling interest earnings stream is a common error, yet one which is fatal to the accuracy of the conclusion.

A minority interest value derived by capitalizing earnings on one of the bases described above is subject to further adjustment if a controlling interest or non-marketable minority interest is being valued. A control premium is typically added to the marketable minority interest value, while a discount for marketability (lack of liquidity) is deducted to

determine the non-marketable minority interest value. Based upon numerous studies, control premiums are generally in the range of 25%-50%, while marketability discounts have a far wider range. Marketability is greatly influenced by the circumstances of the shares being valued. A low marketability discount (range of 5-10%) may be reasonable in one situation, while 60-70% may be justified in another. The key is to relate the marketability discount to the specific factors affecting it.

An alternative approach to valuation is to develop a control value from a capitalization rate based upon sales of controlling interests or use of a discounted cash flow model. It is important to understand that the relationship between the control value and the freely tradeable minority interest value is reconciled by the use of a minority interest discount. Generally in the range of 30% or more from the control value, this discount eliminates the elements of value associated with control of the enterprise. It does not, however, deal with the issue of illiquidity, which is addressed through the further application of the marketability discount.

CHRISTMAS IS JUST AROUND THE CORNER

All too soon we will begin to see advertisements which read "Only 200 Shopping Days Left Until Christmas." These reminders continue right up to the last minute.

No one tells most businesspeople (or their advisors) about the real deadlines for many complex transactions that are often considered toward year-end. In numerous cases, businesses are unable to complete transactions simply because they do not begin planning soon enough.

If you are considering a transaction this year which will require independent appraisal services, remember that the appraisal process takes some time to accomplish effectively. Do yourself (or your client) a favor and avoid the Christmas rush: allow time for the successful accomplishment of all the required elements of your transaction.

Remember, *there are "only 275 planning days until year-end."* This may be the only reminder you receive.

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