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Trapped-in capital gains taxes should be deducted when valuing for divorce

I think it is exceedingly unfair in a marital dissolution property distribution to award an appreciated asset to one spouse without any deduction for the trapped-in capital gains tax while awarding the other spouse property that is free and clear of potential capital gains taxes.

Majority deny discount unless sale imminent

Although some states routinely deduct trapped-in capital gains taxes on appreciated property, the majority of states deny the capital gains deduction unless there is evidence of intent to sell. (For example, see *Owens v. Owens,* p. 7 and *Blevins v. Blevins*, p. 9.)Yet the philosophy articulated in most states is not to require or restrict the activities of either spouse post-divorce.

The implication of denying the capital gains tax deduction is that the operating spouse will continue to operate the business and will be precluded from selling it (or, if he or she decides to sell at some time in the future will realize proceeds less than those on which the property division was based).

Intent of party violates principles of equitable distribution

It seems to me that the *intent* at the valuation date with respect to disposition of the property is irrelevant. The spouse with the distributed property should be free to do with it as he or she wishes without a tax penalty relative to the other spouse. It really isn't a question of *whether* the operating spouse will dispose of it but *when* and *how*. If it is sold, capital gains tax will be owed. If it is transferred to his or her heirs at death, the heirs will not have to pay capital gains tax *per se*, but will owe estate tax on the transfer.

Tax Court recognizes trapped-in capital gains tax

Family law courts frequently follow valuation practices of the U.S. Tax Court. Since 1998 the Tax Court has recognized trapped-in capital gains. In the *Eisenberg* appeal,[1] the Second Circuit commented favorably on the earlier *Davis* decision,[2] and allowed recognition of trapped-in capital gains.

In the *Welch* case,[3] in which the estate had an election to opt out of capital gains tax which they ultimately exercised, the Sixth Circuit said the intent was irrelevant. In *Estate of Dunn*, the Fifth Circuit said that capital gains tax would be deducted "*as a matter of law*"[4] (emphasis added).

Capital gains tax is a liability

Uncertainty as to the future course of action of the operating spouse should not make any difference. The capital gains tax is built in and is a liability against the property. Whether the realization of that liability is imminent should be irrelevant.

[1] *Eisenberg v. Commissioner*, 155 F.3d 50, 1998 U.S. App. LEXIS 20109 (2nd Cir. Aug. 18, 1998).

[2] *Estate of Davis v. Commissioner*, 110 T.C. 530, 110 T.C. No. 35, 1998 U.S. Tax Ct. LEXIS 35 (Tax Ct. June 30, 1998).

[3] *Estate of Welch v. Commissioner*, 2000 U.S. App. LEXIS 3315 (6th Cir. Mar. 1, 2000).

[4] *Estate of Dunn v. Commissioner*, 301 F.3d 339, 2002 U.S. App. LEXIS 15453 (5th Cir. Aug. 1, 2002).

Partnership Spectrum: Resale discount sees little change in 2003

Partnership Re-Sale Discounts Holding Up, *Partnership Spectrum*, May/June 2003, pp. 1-17.

The 2003 annual re-sale discount study in the *Partnership Spectrum* mirrors the results from 2002. Whereas 2002 continued to see a decline in price-to-value discounts for units of real estate partnership interests at 22%, 2003 seems to hold the average discount around 21%. This change is relatively insignificant and may signal the bottom of the cycle of decline that has occurred since 1994. The results of the 2003 study are summarized in *Table 1*.

Seventy-seven partnerships were included in the 2003 study and were broken down into one of the six categories given in *Table 1*. The study recognizes two significant factors that affect the discount rate given to a particular partnership: (1) whether the partnership has the ability to pay operating cash distributions; and (2) the degree of debt financing, if any, utilized by the partnership.

This year's discount remains unchanged primarily because changes within the six categories were offsetting or unchanged. Equity – Distributing for both low or no debt and moderate to high debt partnerships saw only a slight increase over the previous year. Undeveloped land, Triple-Net-Lease, and Insured Mortgages experienced a slight decrease in discounts, and Equity – Non-Distributing saw no change from 2002.

TABLE 1 – SUMMARY OF 2003 RE-SALE DISCOUNT STUDY

Partnership Category	# of Partnerships	Average Discount	Average Yield
Equity - Distributing (low or no debt)	15	16%	8.4%
Equity - Distributing (moderate-to-high debt)	19	27%	6.2%
Equity - Non-Distributing	8	32%	0.0%
Undeveloped Land	3	29%	0.0%
Triple-Net-Lease	26	16%	9.7%
Insured Mortgages	6	15%	9.7%

Court rules use of same dollars for excess earnings method and alimony not double dipping

***Steneken v. Steneken*, 2004 N.J. Super. LEXIS 105 (March 15, 2004).** *Judge Parrillo.*

The issue in this marital dissolution was the perceived "double counting" of the husband's excess earnings from his closely held corporation, **Esco**. The court upheld the trial court's determination that the alimony should be based on the actual income rather than the lower reasonable compensation amount that had been used in valuing the corporation.

Valuation evidence

At trial, both parties submitted expert testimony. Although that testimony was not at issue on appeal, the court used it as a factual backdrop. Wife called three expert witnesses. A real estate appraiser, **Christopher Sullivan**, testified that the value of the corporation's real property was $400,000 as of 1999. A business valuation expert, **Rufino Fernandez**, testified that the value of the company, including the real estate, was $915,000 as of 1996. And finally, an accountant, **Linda Schaeffer**, testified that the effective cash flow of the company for 1998 was $330,072 which included the salaries of the children and all of the perks. If those were not included, the gross income of the company was $200,000.

Husband's business valuation expert, **Kenneth Arlein**, testified that the company, including the real estate, was worth $768,000 as of 1997. Arlein used the capitalization of excess earnings method with a capitalization rate of 24%. Arlein applied that rate to Esco's average annual business income, which was adjusted to include husband's earnings in excess of the reasonable compensation of $150,000 for a CEO in husband's position.

Trial court findings

The trial court determined that the husband's annual compensation was excessive and that, compared with similar CEOs, he should have been earning $150,000 rather than $200,000. The trial court used this adjusted compensation amount in determining the value of the company. The trial court then determined the alimony amount using the husband's actual income of $200,000, thereby including in the alimony calculation what it determined to be his excess compensation.

Holding on appeal and rationale

Husband appealed, arguing that distributing his excess earnings as the goodwill portion of the value of Esco—and also considering it for alimony purposes—was impermissible double counting. The court of appeals disagreed, stating that this was not a case of double counting. It held that the valuation of the marital asset, Esco, was as of the date of dissolution and was based on past excess earnings. The alimony determination, on the other hand, was based on future income.

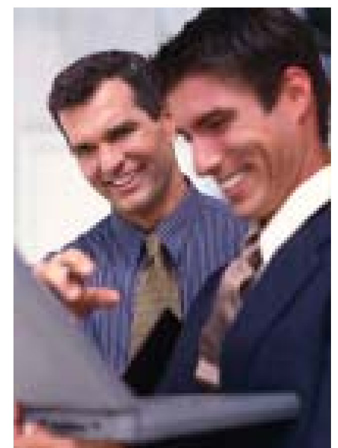
The court stated, "It is simply too categorical to conclude that because an asset is treated as a martial asset for purposes of equitable distribution, it can never be regarded as a partial source of alimony."

The court also noted that even if this was construed to be double-counting, it was not banned by New Jersey law, which bans only the double-counting of pensions. The court noted that an absolute bar "encroaches on the judicial function to consider **all** relevant factors" (emphasis in original). The court upheld the trial court's opinion.

***Editor's Note**: This is clearly a case of double dipping.*

*The culprit is the court's statement that "Excess earnings… is a theoretical construct used to value the goodwill component of a closely-held corporation at a specific point in time… It is a hypothetical figure unrelated to the actual value of the underlying asset on a going-forward basis and as a source of defendant's **future** income stream." [Emphasis in original.]*

The value of a business is the present value of the future benefits that it is expected to produce for its owner(s). It does, indeed, represent the value of the underlying asset (the business) on a going-forward basis. No one would buy a business based on its past earnings if those earnings were not expected to continue in the future. As Revenue Ruling 59-60 states, "Valuation is a prophesy as to the future."



Husband's expert added $57,797 in excess compensation to the business's average annual income as the base used to value the business. He capitalized the adjusted annual income at 24%, a multiple of 4.17. Thus, $240,821 of the business value (4.17 x $57,797) was attributable to the "excess earnings." The wife received a portion of the total value of the business as a distributable asset.

*The court stated "the calculation involved defendant's **past** earnings, not future earnings… to reiterate, valuation of the corporate asset was based on defendant's past earnings, not his future earnings… consideration of defendant's actual income did not result in double recovery to plaintiff essentially because the valuation of the equitably distributed business asset was based on defendant's past, not future, earnings." [Emphasis in original.]*

However, the excess earnings method merely uses past earnings as a proxy for expected future earnings. As Revenue Ruling 68-609 states, "The past earnings to which the formula is applied should fairly reflect the probable future earnings." Obviously, from the language in the opinion, this fact was not made clear to the court in this case.

Thus, to the extent that the $57,797 was used as the basis for alimony, the court used that money twice, once to value the distributed asset and again to determine the amount of alimony. This is a classic case of double dipping, based on a misunderstanding by the court of the basis for the business valuation.

General Economic Conditions IQ 2004

During the first quarter of 2004, the U.S. economy grew at roughly the same rate as during the fourth quarter of 2003 and continued to show strength throughout many of the economic sectors, but inflationary pressures began to rise during the quarter, as well. The gross domestic product (GDP), which is the broadest measure of the economy's health, posted a less-than-expected first quarter figure, but still offered compelling evidence that the economy will continue to sustain moderate growth throughout the rest of the year.

Gross domestic product

The U.S. Department of Commerce reported that the nation's economy grew at an annual rate of 4.2 percent in the first quarter of 2004, as indicated by the GDP, and is slightly above the 4.1 percent rate that was posted in the fourth quarter of 2003, as can be seen in *Exhibit 1*. In 2003, the economy grew by 3.1 percent, compared to an increase of 2.2 percent in 2002 and 0.5 percent in 2001. The 2003 growth rate was the fastest rate since a 3.7 percent increase in 2000. Growth in the first quarter of this year was due in large part to the increase in consumer spending, business investments in equipment and software, government spending, private inventory investment, and exports, but was offset by the increase in imports.

Consumer spending

Consumer spending, which accounts for two-thirds of all economic activity in the United States, grew at a rate of 3.8 percent during the first quarter of 2004. This compares with a 3.2 percent increase in the fourth quarter of 2003 and a 6.9 percent increase in the third quarter. In 2003, consumer spending increased by 3.1 percent, compared with a 3.4 percent increase in 2002 and a 2.5 percent increase in 2001. Consumer expenditures increased the first-quarter GDP by 2.65 percentage points. This compares with a GDP increase of 2.29 percentage points in the previous quarter and a 4.89 percentage point increase in the third quarter of 2003.

Government spending

During the first quarter of 2004, government spending increased at a rate of 2.0 percent, compared with a decrease of 0.1 percent during the fourth quarter of 2003. In 2003, government spending increased by 3.3 percent, compared with a 3.8 percent increase in 2002 and a 2.8 percent increase in 2001. During the first quarter, federal government spending increased by 10.1 percent, compared with a 0.7 percent increase in the previous quarter. National defense spending jumped by 15.1 percent during the first quarter, compared with an increase of 3.0 percent in the fourth quarter of 2003 and a decrease of 1.3 percent in the third quarter. State and local government spending, still hampered by budget woes, decreased spending by 2.6 percent in the first quarter of 2004, after decreasing by 0.5 percent in the previous quarter.

Business investments

Business investments, which have lagged since the 2001 recession, continued to show signs of significant improvement during the first quarter of 2004. Business spending, or nonresidential fixed investment, increased at a rate of 7.2 percent during the first quarter after growing by 10.9 percent in the previous quarter. In 2003, business spending increased by 3.0 percent, compared to a decrease of 7.2 percent in 2002 and a 4.5 percent decrease in 2001. Business expenditures on equipment and software continued to increase during the first quarter at an 11.5 percent growth rate, which follows a 14.9 percent increase in the fourth quarter of 2003. Business spending on structures decreased by 6.5 percent in the first quarter of 2004 after a 1.4 percent decrease in the previous quarter and a 1.8 percent decrease in the third quarter of 2003.

Business inventories

Another encouraging sign during the first quarter of 2004 was the continued increase in private business inventories, which had been kept at low levels during the recent economic downturn. The increase in private business inventories increased the first-quarter GDP by 0.27 percentage points after increasing the previous quarter's GDP by 0.71 percentage points. Businesses built up their inventories of unsold goods at a rate of $15.3 billion in the first quarter of 2004, compared to an increase of $9.0 billion in the fourth quarter of 2003 and a decrease of $9.1 billion in the third quarter. During the recession, businesses cut production sharply and discounted merchandise to get rid of stockpiles of unsold goods, which was a key source of weakness for the economy.

EXHIBIT I: ECONOMIC INDICATORS HISTORICAL DATA

QUARTERLY DATA (Jun 00-Mar03)												
	Jun-00	Sep-00	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03
Real GDP*	6.40	-0.50	2.10	-0.20	-0.60	-1.30	2.00	4.70	1.90	3.40	1.30	2.00
Personal Consumption*	2.50	3.90	3.40	0.50	2.30	1.90	6.20	4.10	2.60	2.00	2.20	2.50
Nonresidential Investment*	14.80	2.20	0.90	-4.50	-13.60	-8.40	-14.00	-7.00	-3.00	-1.10	-0.10	-0.60
Government Spending*	5.50	-2.10	1.30	5.80	5.80	-4.10	7.40	4.60	4.00	2.50	7.10	-0.40
Exports*	12.30	10.70	-2.70	-4.50	-13.40	-17.70	-9.80	4.40	8.70	4.30	-3.70	-2.00
Imports*	16.50	14.10	-1.60	-6.20	-8.60	-10.80	-3.80	8.40	17.10	4.10	8.20	-6.80
CPI (Annualized 3-month % Change)	2.60	2.80	2.10	4.00	3.90	0.70	-1.80	3.00	2.90	2.50	1.60	5.20
Unemployment Rate	4.00	4.00	3.90	4.30	4.50	5.00	5.70	5.70	5.80	5.70	6.00	5.70
Housing Starts (*millions*)	1.56	1.51	1.53	1.59	1.64	1.56	1.57	1.65	1.71	1.81	1.82	1.74

Source of data:
www.bea.gov, www.bls.gov, www.census.gov
Notes:
*Numbers are seasonally adjusted at annual rates.

Tax Court disregards FLP that is disregarded by taxpayer

***Estate of Lea K. Hillgren*, T.C. Memo 2004-46 (December 16, 2003).** *Judge Cohen.*

The issues in this estate tax case were whether the court should disregard a family limited partnership (FLP) under IRC Section 2036(a), and the fair market value of the assets of the partnership.

Facts

Decedent suffered from depression, and following her failed first attempt at suicide, she formed an FLP with her brother, Mark Hillgren, and transferred all of her income-producing real estate to the FLP. Hillgren did not contribute any property to the FLP, but rather contributed his services. He was to receive 25% of the profits of the FLP under the partnership agreement. Decedent committed suicide several months later.

After formation of the FLP, the decedent's relationship to the real property that had been transferred to the FLP did not change. The same management company continued management of the properties in the same manner. Hillgren continued to deal with the properties in the same manner he had before, pursuant to a business loan agreement (BLA) that decedent and Hillgren had previously entered into. All of the FLP's income was distributed to decedent and used for her personal living expenses. Thus, the partnership form was completely disregarded by decedent and Hillgren.

FLP disregarded under § 2036(a)

The tax court ruled that because decedent and Hillgren did not respect the FLP entity, and decedent's relationship to the property did not change after formation of the FLP, the entity would be disregarded for estate tax purposes. Therefore, the real estate held by the FLP was included in the decedent's gross estate.

Valuation of the real estate

Although the FLP was disregarded, several parcels of the real estate were still subject to the BLA. Therefore, in determining the value of the real estate, the expert for the estate, **Carsten Hoffman**, opined that the following discounts should be applied in valuing the University property: 25% for Hillgren's interest under the BLA, 50% for a combined discount for lack of marketability and lack of control, and 5% for a discount for lack of voting rights. Hoffman based the latter two discounts on a comparison of real estate limited partnerships. He presented a similar analysis for the other properties subject to the business loan agreement.

The experts for the IRS, **Raynor Klaris** and **John A. Thomson**, discounted only the University property because the IRS attorney mistakenly told them that it was the only property subject to the BLA. Klaris and Thomson agreed with the 25% discount to account for Hillgren's interest under the BLA. In calculating a 35% discount for lack of marketability and a 10% discount for lack of control, they used a comparison of closed-end equity funds and real estate investment trusts. They also considered six restricted stock studies in the DLOM calculation.

The Tax Court accepted the values opined by Hoffman as "reasonable" and "not contradicted by reliable evidence.

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Business Valuations, Inc.

PO Box 53458
Cincinnati, OH 45253

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