

VALUATION observations



House Resolution 436 Makes Its Way to Ways and Means If Enacted, Estate Tax Relief Act of 2009 Unlikely to be a Relief to Many

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Representative Earl Pomeroy (D - North Dakota) introduced House Resolution 436: Certain Estate Tax Relief Act of 2009 (the "Act"), on January 9, 2009. The Act was subsequently sent to the House Ways and Means committee for deliberation. In addition to setting the estate tax exemption amount at \$3.5 million and imposing a maximum estate tax rate of 45%, the Act would significantly change the valuation of closely-held family businesses. Specifically, the Act would eliminate the application of valuation discounts related to "nonbusiness assets" and would eliminate minority valuation discounts altogether if the minority shareholder is a part owner of a family-controlled entity. Since the Act's introduction in January, the accounting profession has expressed strong disagreement with many of its tenants. The AICPA issued a comment letter on March 20, 2009 to Congress stating the Act would result in overvaluation and would have an adverse effect on small businesses.

Nonbusiness Assets

The Act defines a nonbusiness asset as "any asset which is not used in the active conduct of one or more trades or businesses". The Act states that the value of any nonbusiness assets held by the entity being valued for tax purposes to be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount will be allowed with respect to such nonbusiness assets), and the nonbusiness assets will not be taken into account in determining the value of the interest in the entity. The relative ease or difficulty afforded to companies under the Act to determine if certain assets are "used in the active conduct of a trade" remains to be answered. For instance, cash related to working capital will not be separated from a company as a nonbusiness asset.

For many closely-held family businesses holding real estate, marketable securities, and cash, these assets may be determined to be nonbusiness assets. The elimination of valuation discounts will dramatically increase the value of property being transferred for tax purposes. As it relates to real estate, the real property is a

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business asset only if it is used in the active conduct of one or more real property trades or businesses in which the transferor materially participates and with respect to which the transferor meets the same requirements for participation.

Minority Discounts and Family Owned Businesses

All else being equal, an investment in which the owner is able to control the operations of a company is worth more than an investment in which the owner does not have control. Control is advantageous to an investor because of the ability to make distributions, determine salaries, buy and sell assets, approve a sale of the company, and cause other actions that would affect the value of the business. The Act would eliminate the application of minority discounts for most transfers involving family-owned businesses. The Act states that "in the case of the transfer of any interest in an entity other than an interest which is actively traded, no discount will be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family of the transferee have control of such entity." The term "member of the family" means:

1. An ancestor of such individual,
2. The spouse of such individual,
3. A lineal descendant of such individual, of such individual's spouse, or of a parent of such individual, or
4. the spouse of any lineal descendant

described in subparagraph (3).

AICPA's Comment Letter


The AICPA submitted a comment letter on March 20, 2009 to Congress stating the Act would result in overvaluation due to the removal of certain discounts and would have an adverse effect on small businesses. The AICPA, noting that closely-held businesses are created for multiple non-tax related purposes in addition to the fact that discounts relating to fractional interests are a function of economic reality, advised that the Act should: 1) expand exceptions related to the dismissal of minority interest discounts; 2) narrow the definition of the family attribution rules (i.e., "member of the family") citing that family members often do not act in unity and have contrarian financial goals; 3) clarify the definition of working capital; and 4) generally only disallow discounts in situations where a shareholder is terminally ill and dies shortly after making a transfer to a closely-held business (akin to the concept of Treas. Reg. section 25.7520-3(b)(3)).

Conclusion

Although the Act may not pass (or pass in its current form), it is an important indicator of the position and direction of the IRS and many members of the U.S. Congress. In addition, President Obama through recent proposed changes to the tax code seems committed to increasing government revenue due to the current

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and projected budget deficits. Given the current economic climate, the associated depressed values of real estate and businesses, and the potential elimination of valuation discounts related to many intra-family transfers, now may be the best time to transfer ownership in family-owned businesses from a tax implication standpoint. 

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