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Valuing Ownership Interests in a Closely-held Business

-by Neil E. Harl*

For businesses listed on the various stock exchanges or on an active over-the-counter market, the valuation of ownership interests is relatively simple; the trades of ownership interests represent fair market value for exchanges and for tax reporting purposes as measured by actual transactions. However, relatively few farm and ranch corporations are listed for public trading and so the task is to create a value representing fair market values for use in transactions and or tax reporting purposes but derived from non-market sources.¹ The failure to assure such determinations of value on a regular basis is a major source of conflict in many closely-held businesses, farm and non-farm.

The basic methods for determining value using non-market sources

Over time, several methods of valuation have been developed for closely-held firms with no access to market determinations of value of ownership interests. The valuations from those methods of valuation often vary significantly from each other – and from what is believed to be a fair market value. In some instances, the Internal Revenue Service is likely to challenge the valuations reported to the Internal Revenue Service for gifts or sales of ownership interests; in other situations, the challenge is likely to come from minority owners.²

Here, in brief, are the valuation methods in fairly common use today.

Book value. Essentially, “book value” is typically based on the income tax basis of assets within the firm as shown on the balance sheet. That generally means the basis on acquisition of assets (the purchase price plus improvements made, if any, and minus depreciation claimed for depreciable assets) for taxpayers or entities on the cash method of accounting. The use of “book value” obviously reflects the method of accounting used by the firm.³ The result is almost always a value well below fair market value for cash accounting taxpayers especially. It is important to note whether the firm involved has, in its organizational document or documents, defined “book value.”

For a farm or ranch operation, machinery has often been heavily depreciated (particularly for those years when expense method depreciation (often referred to as Section 179 depreciation) was available up to a limit of \$500,000 (through 2014) and for years when “bonus” depreciation⁴ was available at the 100 percent level without a maximum limit (for acquisitions after September 8, 2010 and before January 1, 2012)⁵ and at the 50 percent level (also without a maximum limit) for eligible acquisitions during 2012, 2013 and 2014.⁶ For a dairy operation or a cow-calf operation the animals in the herd (other than for purchased

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animals and the value of those animals is often deducted as Section 179 depreciation of “bonus” depreciation) often have a zero basis because they were raised by the taxpayer and taxpayers are no longer required to capitalize the costs of raising the replacement animals.⁷ For those on accrual accounting, and relatively few farming and ranching operations are under accrual accounting, plus those *required* to use accrual accounting,⁸ those assets subject to redetermination of value annually at least have a value from the closing inventory closer to fair market value but because of the various inventory valuation rules, inventory value is often less than fair market value.⁹

The result of all of these provisions is that assets, even for accrual taxpayers, are often substantially below fair market value and certainly cash accounting produces income tax basis that peg value well below fair market value.

Appraised value. Some entities, on formation, prescribe appraisal as a solution to the problem of determining fair market value. However, for two reasons appraised value is often rejected as a method of valuation—(1) appraisal has a cost attached and (2) the entity may reject an appraisal conducted by certified or licensed appraisers. Nonetheless, an entity may turn to appraisal as a back-up where the regular method of valuation has not been kept current or is otherwise unacceptable.

The periodically renegotiated fixed price. Perhaps the most workable (and fair) method of valuation of ownership interests is a method in fairly widespread use based on a required annual determination of value by the governing board or the owners of the firm.¹⁰ That method involves a commitment in the articles of incorporation or bylaws for a corporation, operating agreement for an LLC or other organizational document to value, annually, every asset owned by the entity. The burden of accomplishing the evaluation task is generally placed on the governing board of the entity but for small firms it may involve all of the owners. The job is not as great as it might seem, with stored grain valued with local elevator quotes at year end, the local machinery dealer can provide values on used equipment and livestock can be valued based upon quotes obtained from those engaged in buying and selling livestock of the type in question. As for annual adjustments in land values, some states publish the results of land value surveys. Also, some Federal Reserve Districts publish changes in land values in the District.

Once the value of each asset is determined, the sum becomes the updated value for sales of ownership interests, gifts of ownership interests and filing federal estate tax returns and the probate inventory if death should occur over the ensuing 12 months. Ideally, the values of ownership interests in such situations would be determined in a market. This approach uses market-based determinations of value but does so on an item-by-item basis.

One firm, now going into its third generation, has faithfully performed revaluations every year since 1965. That entity, which happens to be a corporation, started with stock valued at \$100 per share and is now just under \$1200 per share some 50 years later. That firm has not missed a year in performing the annual chore of determining stock value. Over that half century, there have been two deaths (of both parents) and the buy-out of stock

of one of the sons whose family had no desire to be involved with the farming operation.

If done regularly, it soon becomes the chief social event of the winter season. Because every owner was either involved in the valuation process (which is preferable) or voted on the final value set per unit of entity ownership, disputes have been rare, almost non-existent, for those pursuing this approach to entity valuation.

A properly drafted provision of this nature also should provide a back-up for valuation (such as appraisal by a qualified appraiser) if it is not carried out on an annual basis. Coupled with the valuation procedure, there should also be provisions for a buy-out term of 10 to 20 years with interest on the basis of a prescribed formula on the unpaid balance or an option by the seller of the interest to accept cash payment at the time of the sale of the interest as well as a specific statement of the restrictions imposed on transfer of ownership interests.

Is such a valuation procedure acceptable for federal income, federal estate and federal gift tax purposes? Such procedures were permitted before 1990 if—(1) the price was fixed or determinable by formula; (2) for estate tax purposes, the estate had to be under an obligation to sell under a buy-sell agreement or upon exercise of an option; (3) the obligation to sell had to be binding during life and (4) the arrangement had to be entered into for *bona fide* business reasons and not as a substitute for a testamentary disposition. In 1990, the Congress (with approval by the President) supplemented the pre-1990 rules in two respects - (1) the 1990 Act provided a general rule that property is to be valued without regard to any option, agreement, restriction “or other right” which set price at less than fair market value of the property;¹¹ and (2) the 1990 Act specified that the general rule would not apply if the option, arrangement, restriction “or other right” met each of the following requirements – (a) it is a *bona fide* business arrangement, (b) it is not a device to transfer value to family members for less than full consideration and (c) the terms are comparable to “similar” arrangements entered into in an arm’s length transaction.¹² The Committee Reports indicate that the 1990 Act was meant to supplement, but not to replace, prior case law.¹³

In 2006, a Tax Court case, *Estate of Amlie v. Commissioner*,¹⁴ was decided involving valuation of bank stock at death. The valuation provision, which contained a fixed and determinable price, was upheld. The exceptions in I.R.C. § 2703(b) were satisfied so I.R.C. § 2703(a) did not provide a basis for disregarding the pre-death agreement.

ENDNOTES

¹ See generally 6 Harl, *Agricultural Law App.* 51B, Article VII (2014).

² See, e.g., *Baur v. Baur Family Farms, Inc.*, 832 N.W.2d 663 (Iowa Sup. Ct. 2013). See also Harl, “The Revolution in Farm Estate and Business Planning,” *___ Estate Planning ___* (2015) (forthcoming).

³ See Harl, *Farm Income Tax Manual* § 1.07 (2014 ed.).

⁴ I.R.C. § 168(k).

⁵ The Tax Relief, Unemployment Insurance Reauthorization,

and Job Creation Act of 2010, Pub. L. No. 111-312, § 401(a), 124 Stat. 3296 (2010).

⁶ The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 331, 126 Stat. 2313 (2012).

⁷ I.R.C. § 263A(d)(1)(A).

⁸ I.R.C. § 447(a).

⁹ See 1 Harl, *Farm Income Tax Manual* §§ 1.07[3][e][i], 1.07[3][e][ii], 1.07[3][e][iii], 1.07[3][e][iv] (2014 ed.).

¹⁰ See 6 Harl, *Agricultural Law App.* 51B, Article VII (2014).

¹¹ Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(a), 104 Stat. 1388 (1990), enacting I.R.C. § 2703(a).

¹² *Id.*, I.R.C. § 2703(b).

¹³ 136 Cong. Rec. 30,488, 30,540-30,541 (1990).

¹⁴ T.C. Memo. 2006-76.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

FEDERAL FARM PROGRAMS

MAPLE SYRUP. The AMS has adopted as final regulations revising the United States Standards for Grades of Maple Sirup (Syrup) to replace the current grade classification requirements with new color and flavor descriptors, and revise the Grade A requirements to be determined free from damage. The USDA Color Standards for Maple Sirup will become obsolete, and color will be determined using a spectrophotometer, or any method that provides equivalent results. The regulations also change the spelling from “sirup” to “syrup.” **80 Fed. Reg. 4853 (Jan. 29, 2015).**

FEDERAL ESTATE AND GIFT TAXATION

ALLOCATION OF BASIS FOR DEATHS IN 2010. The decedent died in 2010 and the executor retained a tax professional to advise on estate tax matters including the necessity to file a Form 8939, *Allocation of Increase in Basis for Property Acquired from a Decedent*. The tax professional prepared the Form 8939 but failed to file the form before January 17, 2012. The estate requested an extension of time pursuant to Treas. Reg. § 301.9100-3 to file the Form 8939 to make the I.R.C. § 1022 election and to allocate basis provided by I.R.C. § 1022 to eligible property transferred as a result of the decedent’s death. *Notice 2011-66, 2011-2 C.B. 184 section I.D.1*, provides that the IRS will not grant extensions of time to file a Form 8939 and will not accept a Form 8939 filed after the due date except in four limited circumstances provided in section I.D.2: “Fourth, an executor may apply for relief under § 301.9100-3 in the form of an extension of the time in which to file the Form 8939 (thus, making the Section 1022 election and the allocation of basis increase), which relief may be granted if the requirements of § 301.9100-3 are satisfied. The IRS granted an extension of time to file the election. **Ltr. Rul. 201504009, Oct. 2, 2014.**

TRANSFEREE LIABILITY. The taxpayers were the executor

of a decedent’s estate and several recipients of property from the estate. The estate paid about half of the estate tax owed when it timely filed the estate tax return. Several years later, two of the recipients agreed to pay the remaining estate tax, interest and penalties in installments; however, the payments ceased before all tax, interest and penalties were paid. The court held that the recipients of estate property were jointly and severally liable for the unpaid estate tax, interest and penalties up to the value of the property received from the estate. The court also held that the executor was personally liable for the unpaid estate tax, interest and penalties because the executor had paid some estate liabilities before fully paying federal taxes. **United States v. Estate of Mabel Hurd, 2015-1 U.S. Tax Cas. (CCH) ¶ 60,687 (C.D. Calif. 2015).**

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued a revised *Rev. Proc. 2015-13*, to permit taxpayers, for Form 3115 filings on or after January 16, 2015 through May 31, 2015, for the forms to be filed under *Rev. Proc. 2011-14, 2011-1 C.B. 330*, or under *Rev. Proc. 2015-13, 2015-1 C.B. 419*, for automatic accounting method changes to choose whether to use *Rev. Proc. 2015-13* or whether to use *Rev. Proc. 2011-14, 2011-1 C.B. 330*, for automatic accounting method changes for their 2014 tax returns. **Rev. Proc. 2015-13, 2015-1 C.B. 419.**

CAPITAL COSTS. In a Chief Counsel Advice letter, the IRS ruled that taxpayers trafficking in a Schedule I or Schedule II controlled substance, such as medical marijuana sold legally in a state, must use the applicable inventory-costing regulations under I.R.C. § 471 as they existed when I.R.C. § 280E was enacted in 1982. The IRS also ruled that it may require a taxpayer trafficking in a Schedule I or Schedule II controlled substance to change to an inventory method for that controlled substance when the taxpayer currently deducts otherwise inventoriable costs from gross income. **CCA 201504011, Dec. 10, 2014.**

CAPITAL GAIN. The taxpayers were related limited liability companies (LLCs) which purchased certificates of purchase of tax lien through tax liens auctions. When a property relating to the lien was not redeemed by the owner, the LLCs obtained a tax deed and