Valuation Viewpoint

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APPROPRIATE CONSIDERATION OF THE CAPITAL GAINS TAX LIABILITY IN MARKET VALUE CONCLUSIONS OF PASS THROUGH ENTITIES

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Introduction

There is considerable confusion about the proper treatment of the capital gains taxes associated with pass through entities when performing business valuations. It is especially problematic when the appraisals are conducted for Gift and Estate Tax purposes. Business valuations are guided by IRS Revenue Ruling 59-60 which defines market valuation, for tax purposes, as follows:

> "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

This definition clearly indicates that market value is the "price at which the property would *change hands…*" (Emphasis added) and is equivalent to what is meant by a transaction, defined as "an agreement between a buyer and a seller to exchange an asset for payment." Thus, fair market value is supposed to estimate the value of the *exchange* between buyer and seller in terms of the sum of money that passes

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MARKET TRENDS AND INDICATORS

Office Buildings	↓	1%
Retail Centers	↑	3%
Industrial Buildings	↓	2%
Apartments	→	0%
New Housing Starts	↑	3.8%
Productivity	↓	2.9%
Composite PE	↓	20
Consumer Confidence Index	↑	94.0

In This Issue …

MARKET TRENDS AND INDICATORS

ECONOMIC INDICATOR

	1998	1999	2000	2001	2002	2003	2nd Qtr 2004
New Housing Starts—Yearly Totals	330,500	347,300	317,500	330,400	349,600	374, 100	168,400

*Midwest Region re-defined in 2002

P/E RATIOS IN SELECT INDUSTRIES

Industry (Year end)	1985	1990	1995	2000	2002	2003	2nd Qtr 2004
Automotive	6	N/M	12	9	16	21	15
Banking	9	14	12	19	13	14	13
Retailing—General*	16	23	22	13	24	22	20
Food & Staples*	14	22	18	24	18	27	27
Fuel-Oil & Gas*	11	15	40	16	26	12	12
Health Care Equipment & Services*	18	22	22	45	22	24	22
Manufacturing—Capital Goods*	20	16	16	20	20	24	21
Service Industries—Commercial*	22	21	18	32	21	24	26
Telecommunications	11	15	21	26	24	21	21
Transportation	18.3	28	21	18	NM	56	41
Utilities*	11	15	17	17	22	19	19
Pharmaceuticals & Biotechnology*	—	—	—	—	24	35	26
Composite	15	17	19	26	29	23	20

*Reporting categories changed in 3rd Qtr 2002 to more accurately identify and report industry activity. NM=not measurable

ECONOMIC INDICATORS

Indicator (5 yr. avg.)	1985	1990	1995	2000	2002	2003	2nd Qtr 2004
Inflation	5.0%	4.0%	3.1%	3.4%	1.6%	2.1%	2.0%
Productivity	1.7%	0.6%	1.5%	2.9%	4.7%	8.6%	2.9%
GDP	4.0%	1.8%	2.7%	3.8%	2.4%	3.1%	3.0%
Consumer Confidence	84.9	104.2	99.2	128.6	64	91.7	94.0

RATES OF RETURN AND RISK HIERARCHY

Investment	Current
30 Year Treasury	5.3%
Aaa Bond	5.9%
Bbb Bond	6.5%
Commercial Mortgage	6–7%
Institutional Real Estate	8–9%
Non-Institutional Real Estate	9–11%

Investment	Current
Speculative Real Estate	11–15%
S & P Equity (Ibbotson)	12.3%
Land Development	12–17%
Equipment Finance Rates	14%
NYSE/OTC Equity (Ibbotson)	15.3%
NYSE Smallest Cap. Equity (Ibbotson)	18.3%

Sources: National Real Estate Index (2004), Appraisal Institute; F.W. Dodge Division, Business Week, Value Line, U.S. Chamber of Commerce, Standard & Poors, Investment Dealers Digest, U.S. Government Census.

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SHENEHON ONLINE

BY SCOT A. TORKELSON

The benefits of being connected to the Internet are undeniable. Without question, this accessibility is one of the greatest innovations for the workforce, appraisers included, of all time. It places data at our fingertips in ways we never thought possible. However, there is a growing number of users who have learned that the Internet doesn't only allow us to look OUT. It allows the whole world to look IN as well.

When email was first widely used, in the mid 1990's, it became one of the most quickly adopted new technologies in history. It didn't take long before unwanted advertising appeared in your Inbox. SPAM —that's slang for junk email—now composes 90% of all email received. That is the least of it. Viruses, adware, trojan horses, strings, ants and any number of unwanted programs and monitoring devices are finding ways to enter your computer. It is a very serious problem. Legitimate users of email are turning away from the medium, frustrated by mailboxes filled with ten, fifty or a hundred unwanted messages every day. How can you protect yourself? Here are a few simple steps.

1) **Install Virus Protection and/or make sure yours works**—Just because you have anti-virus protection does not mean it is working. Check and check often. The most common program is Norton Antivirus. However, in new computers, it generally comes with only a 30-day trial which requires registration to continue working. Did you let yours lapse? The cost of no protection is a computer filled with viruses.

2) **Install a Firewall**—Keeping the viruses from entering your computer is an even better first step. There are programs that automatically install themselves on your computer anytime you open a site. The click to open a site is also a "yes" to install the virus software; it may slip by your antivirus software undetected. However, with a firewall, the virus program is denied installation access. A firewall creates a secure area that stops snooping and unwanted access into your computer. If you have Windows XP there is a built-in firewall system that you simply turn on (for some reason it defaults to "off" during the installation process). Go to help and type: firewall. You will find step-by-step instructions for turning it on again.

3) **Secure your Browser**—The main source of unwanted email is actually residing in your Browser. It is called a cookie and it's not the kind you eat! Every time you enter a site, something called a cookie can be sent to your computer. The cookie places a bit of information about who you are (at least that you went to this site) on your computer. SPAM uses this information to direct unwanted email to your computer. If you go to the Wells Fargo site, for example, you may have indicated to junk mailers where you bank. Their software can follow your cookie crumbs. You can deactivate the cookies or be warned every time a program sets a cookie. Go to the Tools Tab and find the Cookies setting. If you trust the site and don't mind a piece of information from them, let the cookie be set. Otherwise reject it. Also clear out your cookies at least once a week.

4) **Get Rid of the Freebies**—Are you running a weather program on your screen? Like that nice screen saver program that changes your landscape? Did you know it's likely you installed a program that could be monitoring your every keystroke and sending it to someone. Get rid of these programs. Sometimes a harmless little freebie can increase your junk mail by 50%.

This is a good start. Next issue we will focus on what you can do within the email program itself. Good Luck. VV

CREATIVE OPPORTUNITIES IN THE CURRENT REAL ESTATE MARKET

BY STEPHEN T. HOSCH

The commercial real estate market has always been cyclical, ranging from strong growth periods to extremely overbuilt conditions. During the last cycle, the market shifted from a commercial development boom in the late 1980's to an extremely overbuilt condition by the early 1990's, before rebounding again in the mid to late 1990's.

In the early 1990's, overbuilt conditions in the market resulted in numerous bank foreclosures and "fire sales" (deeds were transferred in lieu of foreclosure), with the former owner losing most, if not all, of the equity. The lenders accumulated a large, unwanted supply of real estate. Most of these properties had high vacancies, deferred maintenance, and/or functional obsolescence. Those buyers who had the financial resources to meet the equity requirements of the initial purchase of these properties and the carrying costs prior to reaching stabilized occupancy (the new mortgage payment, leasing costs, curing deferred maintenance, etc.), realized significant capital gains by selling these same properties prior to 2000.

Ten years later, as we find ourselves in the overbuilt phase of yet another cycle, few distressed properties are going through foreclosure or being sold, in lieu of foreclosure, at deep discounts when compared to the last market cycle. The primary reason for the lack of a buyer's market within the last few years has been the ability of property owners to refinance at record low interest rates in order to "ride out" the current recession. Those few properties, with high vacancy rates or sitting empty, that have been available on the market have not transacted at the record low prices one would expect. The sellers are more patient, creating large disparities between the asking price and actual bids.

> *"Four creative opportunities have been identified in this article that may provide higher returns in the current environment."*

In light of the limited opportunities for buyers looking for significant equity growth by purchasing troubled properties, other avenues are being pursued. These generally require a greater level of buyer sophistication in order to realize even the gains that were considered to be at the low end of the levels experienced by sellers of repositioned properties in the late 1990's.

Four creative opportunities have been identified in this article that may provide higher returns in the current environment. They are: (1) Redevelopment of Obsolete Properties; (2) In-fill Development; (3) Repositioning of Existing Properties, and; (4) Conversion of Existing Properties.

Redevelopment of Obsolete Properties

As the Twin Cities Metropolitan area continues to expand, commuting times have increased exponentially. Obsolete and/or underutilized properties possessing the proper demographics as well as general locational and site characteristics can become candidates for redevelopment into single- and multi-family housing sites or new commercial developments.

Numerous successful redevelopment projects can be observed throughout the metro area. Of particular note are: the new Best Buy headquarters in Richfield, the new Target store and headquarters in downtown Minneapolis, Medtronics new world headquarters on the former 100 Twin Drive-In Theater site in Fridley, the Quarry shopping center off of I-35W in Minneapolis, and the new Science Museum of Minnesota in downtown St. Paul.

Demolition of existing buildings, soil correction, and other site preparation costs can make redevelopment very costly. In many cases, redevelopment is not economically feasible without some form of public assistance. Buyers and developers of these sites are at a competitive disadvantage considering the total site development costs for redevelopment projects. A general knowledge of the public development tools currently available is crucial to successful redevelopment. Tax Increment Financing (TIF), tax abatement, development grants, public financing and others are common.

In-Fill Development

In-fill sites are still available, although they are becoming more scarce. The question that must be answered is: "Why has the site not yet been developed?" Poor soils, on-site contamination, title problems, challenging topography, zoning constraints, and properties that have been developed on odd-shaped oversized lots are all possible answers. For example, 25 to 30 years ago, as the rest of the neighborhood developed, soil correction costs of a particular site were perhaps too high to justify its development. However, as strong demand for in-fill sites has driven up prices for ready-to-build sites, correction of the poor soils may now be economically feasible. Depending on the impediments which exist, a current cost benefit analysis may provide an opportunity for the informed buyer. Two very successful in-fill developments are the spec office building developed on the southwest quadrant of Highways #62 and #169, and the single-family residential developments on shore-line cul-de-sacs carved out of large estates along Meeting Street in Minnetonka.

"However, as strong demand for in-fill sites has driven up prices for ready-to-build sites, correction of the poor soils may now be economically feasible."

Repositioning of Existing Properties

There are few opportunities providing for significant upside in the current marketplace when buying properties based on existing cash flow and/or use, unless the property has experienced a high degree of functional obsolescence. This may be due to a shortage of on-site parking, poor visibility, and/or lack of windows within a commercial property, or few to no amenities in an apartment complex. By purchasing or leasing adjacent property to cure the parking shortage and/or access problems for the commercial property and adding some windows, a sale of the property upon reaching stabilization can result in measurable capital gains.

An apartment complex that can accommodate new garages, rearrangement of unit mix, new appliances, and cosmetic updates, to better compete within its immediate market, can generate substantially higher net operating income through rent increases and higher occupancy rates.

Conversion of Existing Properties

Sometimes a property reaches a point when repositioning is no longer physically possible or economically feasible. In these cases, either redevelopment or conversion of the existing structure remain. Ultimately, the property has to meet a minimum set of criteria to be considered competitive in the marketplace following a conversion. For example, a turn-of-the-century multi-story industrial building, located in the middle of a vibrant industrial neighborhood, may possess excellent architectural characteristics for conversion into a residential loft condominium project. Unfortunately, it may not meet the general location and demographic criteria required for a successful residential conversion. However, the same building, located on a river front site in a little used industrial area might

"Ultimately, the property has to meet a minimum set of criteria to be considered competitive in the marketplace following a conversion."

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across the table from buyer to seller in exchange for an asset.

A proper understanding of just what fair market value measures is critical to the proper determination of value; if what we have just described is the definition of fair market value, then it is NOT a net proceeds estimate of value to a seller. Fair market value is NOT an estimate of what the seller received after paying all expenses associated with the sale—broker's fees, listing fees, capital gains taxes, debts, etc. These are all costs incurred by the seller personally and they are not part of the exchange, these costs are the seller's alone and do not change hands from the buyer to the seller.

> "*...fair market value is supposed to estimate the value of the* exchange *between buyer and seller in terms of the sum of money that passes across the table from buyer to seller in exchange for an asset.*"

Nor is fair market value an estimate of value from the buyer's position apart from the exchange, which may include costs incurred in finding a business to buy, or exercising due diligence before buying the asset. Any broker's fees, legal costs, and any other expenditures of the buyer are likewise not considered a part of the transaction between buyer and seller.

The confusion around fair market value conclusions stems precisely from a wandering off from the focus on the "changing of hands" or the "exchange between a willing buyer and willing seller" by the appraiser, who erroneously includes those costs or circumstances which are related to the seller or buyer alone. Nowhere is this more true than the deduction of capital gains taxes; they are not part of the exchange, but are costs of the seller only.

Simple Discussion of Capital Gain Taxation for Pass Through Entities

We begin with a simple example. If a Sole Proprietorship (the simplest of pass through entities) owner were to sell a business for $5,000 that had been purchased for $4,000 (basis), then the seller must pay a capital gains tax on the $1,000 gain. The tax is paid at the time of the sale. Assuming a personal tax rate for pass through entities at 20%, a total of $200 would need to be paid by the seller and the net proceeds of the sale would be $4,800.

What is the fair market value of the business? In this example, the fair market value is $5,000, or the price at which the sale transacted, was exchanged, between the buyer and seller—this amount is what the buyer paid to the seller. It is not the $4,800 net proceeds realized by the seller after payment of capital gains tax because the payment of the capital gains tax was by the seller only; it was not part of the exchange. On the buyer's side of the transaction, if a consultant had been hired to find the business and the buyer had paid a $200 finder's fee, that also is not part of the fair market value because the $200 was not paid from the buyer to the seller. It was part of the buyer's own due diligence.

THE TRANSACTION LOOKS LIKE THIS

Seller	Transaction	Buyer
Transaction $5,000	$5,000	Transaction $5,000
Cap. Gain ($200)	Market Value	Consultant $200
Net Proceeds $4,800		Total Cost $5,200

Regarding the example above, business appraisal principles and definitions clearly state that the focus of fair market value is on the point of exchange between the buyer and the seller. Thus, the focus is on what a buyer would pay for a given asset or business, irrespective of the seller's tax or other considerations associated with the seller alone. The question which the appraiser must ask is: in the example above, would a buyer pay any more or less for the pass through entity to account for the fact that the seller might incur personal liabilities associated with the sale, such as a capital gains tax? The answer is no. It does not figure in the exchange. There is no derived benefit or detriment to the buyer with regard to the seller's situation. It is therefore not a part of the transaction.

To complicate matters further, the seller of a business, real estate or capital asset can frequently avoid the capital gains tax altogether by reinvesting the sales proceeds into another, similar, capital investment. One cannot be assured that a capital gains tax will be paid by the seller even when there is a capital gain, providing us with additional evidence that capital gains taxes are not part of the transaction.

> *"Nowhere is this more true than the deduction of capital gains taxes; they are not part of the exchange, but are costs of the seller only."*

Description of Pass Through Entities

The previous example reflects a Sole Proprietorship. A simple business structure of this nature shares many similarities with other, more complicated, pass through business entities. Sole Proprietorships, Limited Liability Companies, Partnerships and S Corporations are all pass through entities. This means that in each of these businesses, the entity structure does not pay taxes at the corporate level. Rather, all taxes "pass through" to the individual owners at their personal tax levels. For example, company earnings are "passed through" to the owners as if they had earned the profits personally, therefore taxes are paid on their proportionate share of the business earnings at their own individual tax rates.

> *"When owners of an S Corporation sell their interests, they pay capital gains taxes on the gain in fair market value from basis at their personal tax levels."*

S Corporation Example

When owners of an S Corporation sell their interests, they pay capital gains taxes on the gain in fair market value from basis at their personal tax levels. These gains are adjusted upwards for any interim distributions they have received and decreased by any allocations of earnings on which they already paid taxes. In a pass through entity, the basis and capital gain are held personally (by each owner), until it is sold. The purpose of the pass through entity is to allow owners to avoid the double taxation, on corporate earnings, that applies to C Corporations, where the company pays taxes on profits and the owners pay taxes when the profits are distributed. At the same time, the gains/losses on capital investments are passed through to the owners personally as well and cannot be "trapped in" at the corporate or business level, as occurs with C Corporations. Because all earnings pass through to the owners, capital gain liabilities are not relevant to the transaction between a buyer and seller. Pass through earnings cannot be part of the fair market value consideration.

Thus, if a shareholder sells or redeems his or her S Corporation stock, the shareholder recognizes a capital gain or loss equal to the difference between the consideration received and his or her basis in the S Corporation stock at origination plus increases or decreases in the account equity. There is no instance of capital gains being trapped in and passing to the new buyer as is the case for the sale of C Corporation stock.

In the case of a partial interest sale, a 100% stock sale or even when the S Corporation is liquidated, the shareholders recognize a capital gain or loss on the difference between the fair market value of the property received and their respective basis in the S Corporation stock surrendered based upon their own personal capital positions in the company. In each instance, the capital gains tax is payable by the owners/sellers of the S Corporation interest personally. The seller's basis is measured against the purchase price and there are no trapped capital gains taxes passed to the buyer. Therefore, this cost cannot be a part of fair market value consideration. That is the essence of a pass through entity. Our S Corporation example is true of Sole Proprietorships, Partnerships, and Limited Liability Corporations as well.

> *"The purpose of the pass through entity is to allow owners to avoid the double taxation, on corporate earnings, that applies to C Corporations..."*

C Corporation Example

While the previous example applied to pass through entities, it may not apply to entities which do not pass through, but retain their earnings. A C Corporation is a business entity whose earnings/losses do not pass through to the owners. Losses, earnings, proceeds from asset sales, and other sources of income for the business are retained by the C Corporation. The basis of the stock for the shareholders does not match the basis of the assets inside the corporation.

As a result, capital gain liabilities can be trapped inside a C Corporation entity without passing through to the shareholders. Various events, as simple as the depreciation of corporate assets, result in a declining balance of the basis, inside the business, apart from the basis of the shareholders' stock. Assume, for example, vacant land or building improvements with a basis of $1,000,000 and a fair market value for the same asset of $5,000,000. The C Corporation has trapped in a gain of $4,000,000, with capital gains tax exposure of $800,000* (assuming an immediate sale). The stock can sell without the real estate held inside the Corporation transacting, and this capital gains tax exposure is "trapped in."

Thus, if the C Corporation were to sell stock, the sale would include the capital gains tax exposure as a part of the exchange between seller and buyer. In the case of C Corporations, the capital gains tax liability can change hands when it is "trapped in," and is, therefore, a part of the transaction from the seller to the buyer. As a part of the exchange, it may also be a factor in the fair market value considerations of the appraiser. (Discussion of additional considerations is outside the scope of this article.)

Would buyers pay less for a C Corporation knowing that they would be incurring an $800,000 trapped in capital gains cost? Assuming a stock sale in the future, the owners of the newly acquired company would have to pay this cost. In this instance, the answer is a resounding yes. The buyers need to

THE SALE LOOKS LIKE THIS

Seller	Transaction	Buyer
Transaction $10,000,000	$10,000,000	
Trapped Gain ($800,000)	($800,000)	Pays
Net Proceeds $9,200,000	$9,200,000	$9,200,000
	← Market Value	

* The estimated capital gains tax is for example purposes only and does not reflect the actual tax rate which may be applicable.

ascertain when that trapped in cost will be incurred and how much it will be. It is not necessarily a dollar for dollar reduction of the capital gains tax liability. Nonetheless, this cost would certainly be of concern to potential buyers. It is a part of the transaction and, by definition, a contributing factor to determining fair market value.

Appropriate Deductions of Capital Gains Taxes

When is it appropriate to deduct capital gains taxes from a transaction or to include it in a fair market value conclusion? The issue of consideration of trapped in capital gains taxes in C Corporations has been discussed in several prominent Court Cases. The Second Circuit, in *Eisenberg*, set forth its rule regarding the consideration of trapped in capital gains as follows:

> "Fair market value is based on a hypothetical transaction between a willing buyer and a willing seller, and in applying this willing buyer-willing seller rule, *'the potential transaction is to be analyzed from the viewpoint of a hypothetical buyer whose only goal is to maximize his advantage…. [C]ourts may not permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer….'* Our concern in this case is…what a hypothetical buyer would take into account in computing fair market value of the stock. We believe it is common business practice and not mere speculation to conclude a *hypothetical willing buyer*, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole assets of the Corporation at issue in making a sound valuation of the property." *Eisenberg v. C.I.R.*, 155 F.3d 50, 57 (2nd Cir. 1998)(emphasis added)

The rules are even put more forcefully by the Fifth Circuit Court in *Dunn v. Commissioner* ___ F.3d ___ (5th Circuit 2002). The following quotes are taken from *Dunn* (emphasis is added):

"We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subject desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the *asset*-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business' assets must be considered as a dollar-for-dollar reduction when calculating the *asset*-based value of the Corporation, *just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's* earnings *based value*." (in footnote 24, *Dunn* elaborates on this point by citing Pratt for the proposition that the tax consequences of ownership and/or transfer of stock usually are quite different from those of ownership and/or transfer of direct investment in underlying assets.)"

> *"There is no instance of capital gains being trapped in and passing to the new buyer as is the case for the sale of C Corporation stock."*

"This truism is confirmed by its obverse in today's dual, polar-opposite approaches (cash flow; assets). *The fundamental assumption in the income or cash-flow approach is that the assets are* retained *by the Corporation, i.e.,* not *globally disposed of in liquidation or otherwise.* So, just as the starting point for the asset-based approach in this case is the assumption that the assets are sold, *the starting point for the earnings-based approach is that the Corporation's assets are retained—are* not *sold*, (other than as trade-ins for new replacement assets in the ordinary course of business)—*and will be used as an integral part of its ongoing business operations.* This duly accounts for the value of assets—unsold—in the active operations of the Corporation as one inextricably intertwined element of the production of income."

It is important to note that in both of these cases, the Court is dealing with C Corporations; companies which can have trapped in capital gains. The same arguments would not apply to pass through entities: sole proprietorships, Limited Liability Companies, Partnerships or S Corporations because buyers in these types of entities purchase the company and book the purchase price at its basis. There is, in no instance, the possibility of a trapped in capital gain for pass through entities, which occur only in C Corporations. *Eisenberg* and *Dunn* stand for the proposition that, in determining whether to reduce fair market value for capital gains tax, the appraiser is to look at the sale from the buyer's point of view when determining what a buyer would be willing to pay a seller for his/her stock. Thus, a reduction for trapped in capital gains would only be applicable to C Corporations, because only these business entities have a situation where capital gains taxes can be trapped in and passed on to the buyer. The Courts found that a seller can only seek payment and that a buyer will only pay for a future benefit or detriment that the buyer receives (or perceives him/herself to receive). That is the only value which actually transacts and the only one allowed to be considered within the fair market value conclusions.

> *"The stock can sell without the real estate held inside the Corporation transacting, and this capital gains tax exposure is "trapped in.""*

It is also important to note that the capital gains tax discussed in all of these cases are the taxes payable by the Corporation itself, not the owners or shareholders. In S Corporations, there is no corporate tax of any kind because there is no corporate level (which is the essence of a pass through entity). When a Corporation is sold, only those taxes payable by the Corporation are considered a part of the transaction. Taxes owed by the owners (sellers) do not reflect in any transaction between the buyer and the seller. In all of the pass through entities, the capital gains taxes are paid only by the owners (sellers). To reiterate, the capital gains taxes cannot pass from the seller to the buyer and can never be a part of the transaction, which is, by definition, the basis of fair market value.

There is considerable confusion precisely at this point. Valuators continue to apply capital gains tax costs, which are payable by the seller only (within these pass through entities), and which are not a part of the corporate burden nor a part of the transaction from the seller to the buyer. In the absence of such a transfer, no buyer would give such costs consideration when his/her own basis is un-impacted by the capital gains taxes paid by the seller. The gains are not trapped in within the entities of Sole Proprietorships, Limited Liability Companies, Partnerships, and S Corporations. Any application of the costs of capital gains taxes are inappropriate in market valuation, just as inappropriate as netting out such costs in the sale of any asset—whether real estate, business entity, or otherwise.

> *"The buyers need to ascertain when that trapped in cost will be incurred and how much it will be."*

Exceptions

Are there any exceptions for S Corporation sales considering built in capital gains? There may be a sole exception:

the sale of the S Corporation occurring within 10 years of the S Corporation conversion. In such cases, for tax purposes only, the entity reverts to being considered as a C Corporation. The IRS recognized that shareholders could abuse the benefits associated with the S Corporation status by choosing to elect as an S Corporation immediately before selling the business. In order to prevent this possibility, the "built-in gain" rule was created.

Whenever an existing C Corporation elects S Corporation status, the difference between the fair market value of its assets and the basis of such assets, on the date of the S election, is its "built-in gain" and this gain holds true for 10 years after the S Corporation election. If the assets are sold within 10 years of the election, the gain on the sale of the assets will revert to consideration as if it were still a C Corporation. Therefore, the S election must occur at least 10 years before the sale in order to avoid being treated as a C Corporation with the usual C Corporation considerations. The primary consideration here is the single and double taxation issue (the main difference between C and S Corporations), but it may also involve the issue of trapped in capital gains.

We are not considering what the appropriate fair market value principles are, in this situation, but given certain facts and circumstances they can be very unique. It is outside the scope of this discussion, but we do recognize this particular circumstance when the issue of trapped in capital gains taxes could apply to an S Corporation.

> "*The potential capital gains tax liability in an S Corporation, or any of the pass through entities, cannot be part of fair market value conclusions...*"

Conclusions

There is considerable confusion about the proper treatment of the capital gains taxes associated with market valuations of businesses, particularly when the appraisals are conducted for Gift and Estate Tax purposes. However, fair market value is clearly identified in Revenue Ruling 59-60 as the "price at which the property would change hands." It is, therefore, a transaction price: the monies that are exchanged from buyer to seller. It is not a net proceeds of the seller, or what the seller receives after paying all of the expenses associated with the sale. It makes no difference whether the fees are broker's fees, listing fees, capital gains taxes, debts, etc. These are all costs incurred by the seller, they are not transactions which exist between the buyer and the seller, nor do they have any benefit or detriment to the new buyer.

The potential capital gains tax liability in an S Corporation, or any of the pass through entities, cannot be part of fair market value conclusions for Gift and Estate Tax Purposes (or for any valuation purpose for that matter) because the issue of basis increase (or decrease), subject to capital gains is passed through and payable by the owners only. Depreciation costs are passed through to the owners, all benefits from sale of assets, and the appreciation of assets at the time of sale pass through to the owners with capital gains taxes payable by the sellers only. Therefore, it cannot be part of the transaction.

Any references to the *Eisenberg* and *Dunn* Cases apply to C Corporations only. It is only in C Corporation entities that trapped in capital gains taxes may be considered in market valuations precisely because the tax liability can pass from the buyer to the seller when it is trapped in the corporate structure and not passed through to the owners. In such situations, the buyer must consider the liability costs associated with trapped in capital gains within the transaction. In pass through entities there is no such provision for the capital gains tax liability to pass from the seller to the buyer, so it cannot be considered part of the transaction, and, by definition, cannot be considered within the fair market value calculation. VV

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provide just the right combination for conversion to a multi-family residential neighborhood. Examples of successful conversions from industrial to residential neighborhoods can be observed in the condominiums along the Mississippi River in downtown Minneapolis' historic warehouse district, (Northstar Lofts, Washburn Lofts, etc.), in Duluth's Canal Park area, (Hawthorne Suites/Suites at Waterfront Plaza), and in downtown St. Paul, (Lowertown Lofts and the new Mississippi River front developments).

The feasibility of conversion versus redevelopment may be very close. The ultimate decision may depend on whether the existing shell can physically be converted and at a cost low enough to provide an adequate return to the developer. The following table explores examples of potential conversions based on a cost-benefit analysis.

"By paying attention to real estate cycles and changes in market conditions, the creative investor may still find opportunities for significant equity growth in today's market."

As the table illustrates, the first two examples appear to be economically feasible, while the third example does not provide enough profit. The property in the third example will have to experience stronger appreciation in value as a converted residential condominium. Price increases in the value of the condo units will have to outpace the costs after construction in order to be considered feasible for future conversion. Properties like this could easily provide one of tomorrow's investment opportunities. This article focuses on redevelopment properties, but these strategies apply equally well to other property types for investment purposes. By paying attention to real estate cycles and changes in market conditions, the creative investor may still find opportunities for significant equity growth in today's market. VV

EXAMPLES OF POTENTIAL CONVERSIONS

	Vacant Industrial Building to School Use (per square foot)	Vacant Industrial Building to Residential Condominiums (per square foot)	Vacant Office Building to Residential Condominiums (per square foot)
Acquisition Cost	$20	$17.50	$35
Conversion Costs	$55	$150	$150
Total Cost After Conversion	$75	$167.50	$185
Value After Conversion	$90	$195	$195
Indicated Developer's Profit	$15 (20%)	$27.50 (16.42%)	$10 (5.41%)
Conversion Feasible?	Yes	Yes	No

MARKET TRANSACTION: BUSINESS VALUATION
CREATIVE SOLUTIONS TO COMPLEX CORPORATE PROBLEMS

Problem—Company Under Threat of Condemnation

Established Rendering Plant
123 Main Street
Any City, Your State

After more than 50 years in business, the subject company found itself under the threat of condemnation by the city in which it was located. The plant was very old, but clearly functional. The equipment was constantly in need of updating and repair leading to large expenditures for capital improvements. The rendering industry was in the worst economic position ever, resulting in significant revenue declines and a loss of profitability never before experienced. On the positive side, the company was in excellent health from a balance sheet perspective. The subject company had equity of over $1.2 million, accumulated over many years of profitability. This enabled them to weather downturns in the industry and make whatever capital expenditures were necessary. To make matters even more complex, the industry was rebounding and the owners were approaching retirement age.

In order to assess the potential damage caused by condemnation of the property, the business owners proceeded as follows:

a. Hired a good attorney.

b. Hired a relocation expert.

c. Hired Shenehon Company to assess the value of the business and the real estate.

d. Enlisted Shenehon Company's expertise to guide them through the condemnation process.

In addition to the uncertainty of when, or if, a condemnation of the property would occur, other issues remained unclear. The following list of questions was developed to aid in the analysis of the company:

- If our property is condemned, what will I get paid?
- Should the company relocate its facility?
- If relocation is advisable, how much will it cost?
- Will the company be able to find relocation opportunities within its trade area?
- Will the city compensate the company for the building, the plant, new equipment, and/or moving expenses?
- Will the city reimburse the company for the loss of going concern, in addition to the real estate and equipment, if so, how much?

Business Description

The subject company operated as a rendering plant. Rendering operations perform the necessary service of disposing of restaurant grease and animal waste carcasses. At the present time, waste of this nature cannot be legally disposed of in landfills. Therefore, without rendering plants, restaurants, grocery stores, and meat processors would have no legal way of disposing of their organic wastes.

This rendering company employed a process known as "batch processing". The raw material is fed into specialized machines that mix bone and other waste materials on a measured basis. The mixture then travels through a magnetic separator in order to remove any metallic substances. From there, it is placed in cookers which separate the tallow from the meal. Both the tallow and the meal are dried thoroughly in pressurized separators. The tallow and meal can now be re-used as ingredients in animal feeds of various grades.

Revenues are generated in two ways: by charging a service fee for pick-up of the waste materials and by selling the end products, tallow and meal, in the marketplace as animal feed.

The plant and office of the subject business operate on 6 acres of land. The business owns the real estate and the plant includes highly specialized equipment.

INCOME STATEMENT & EQUITY SUMMARY (IN THOUSANDS)

	1997	1998	1999	2000	2001	2002
Revenue	$2,879	$2,730	$2,081	$1,804	$1,658	$1,802
Operating Profit Before Tax	$ 220	$ 143	$ (188)	$ (43)	$ 189	$ 278
% Profit	7.6%	5.2%	(9.0)%	(2.4)%	(11.4)%	15.4%
Total Assets	$1,378	$1,429	$1,246	$1,184	$1,004	$1,293
Total Liabilities	$ (70)	$ (10)	$ (12)	$ (0)	$ (10)	$ (22)
Net Equity	$1,308	$1,419	$1,234	$1,184	$ 994	$1,271

SALIENT DATA

Rendering Plant

Business	Rendering	
	6 year Average	*2002*
Revenues: (in thousands)	$2,159	$1,802
Net Profit Before Tax:	39	278
Average % Profit: (in thousands)	1.8	15.49

Purchase Price

Goodwill and moveable equipment:	$760,000
Net Asset Cash Plus Account Receivable Less Liabilities:	$909,000
Real Estate Including Non-Moveable Equipment:	$1,275,000
Total Purchase Price:	$2,944,000

	6 year Average	*2002*
Multiples of Average Revenues:	1.36	1.63
Multiples of Average Earnings:	75	10.5

Owners' Decision

After an in depth analysis of all relevant factors, the decision was made to sell the business intangibles, i.e. goodwill (customer list), and approach the city to purchase the land, building, and fixed equipment.

This approach was taken for the following reasons:

- The law is not clear on the compensation of goodwill.
- The equipment was old and appeared ready to collapse, to the uneducated observer; it would be difficult to persuade the condemning authority that the equipment was functional and valuable to the operation.
- It was clear that the property would be condemned, but it could take as long as five years before this officially took place. The prospect of a long legal battle over many years, with an outcome that could not be estimated, was very unsettling to the owners: there were too many unknowns. Based on the appraisals and other expert opinions, the owners did have a clear understanding of the worth of their assets, but it was also clear that the city could not afford to pay the owners what was proper and would, therefore, fight on all fronts to reduce what the owners thought was fair.
- Overall, it was felt that we could control more of the money issues by pursuing a sale.

General Comments

By being pro-active, the owners were able to maximize value. The sale was a combination of hard assets and goodwill. Due to the complex nature of the transaction, it took over 18 months to close on both the business and the real estate. Even though it took 18 months from start to finish, if the owners had, instead, waited for condemnation to occur, they might still be waiting to be condemned and would face a great deal of uncertainty with regard to the notification of the date of the condemnation as well as the continued operation of their business. By hiring qualified experts at the front end, the owners were able to minimize their risks and maximize their sale price. VV

MARKET TRANSACTION: REAL ESTATE

Property:	Future Research and Development Facility for Ecolab 655 Lone Oak Drive Eagan, Minnesota
Buyer:	Ecolab Inc.
Seller:	CCPRE-Eagan, LLC
Source:	Buyer
Sale Date:	April 2, 2004
Sale Price:	$17,500,000
Unit Price:	$34.87
Net Rentable Area:	501,800 (single tenant)
Gross Building Area:	501,800
Zoning:	PD, Planned Development District
Utilities:	All available
Topography and Soil:	Rolling, assumed stable
Visibility and Access:	Good
Age:	1989, 1990
Land Size:	89.65 acres with excess land available and approved for 500,000 square foot expansion
Remarks:	Large campus/headquarters setting; includes four connected buildings. Buyer intends to renovate buildings and add 24,000 square feet of space. Special features include: data center space with raised flooring, workout center/gym with locker rooms, cafeteria and outdoor athletic fields. A significant amount of personal property was involved in the sale, including office furniture and equipment, kitchen equipment, 5 UPC systems, and exercise equipment.

SCOPE OF SERVICES

Shenehon Company is a Real Estate and Business Valuation firm, serving both the private and public sectors throughout the United States. Our unique combination of real estate and business valuation expertise allows us to provide a wide range of services and to offer innovative solutions to difficult valuation issues. Obtaining accurate and reliable industry information and expertise should play a key role in any decision-making process, and Shenehon Company is dedicated to equipping its clients with the tools necessary to make informed and knowledgeable decisions regarding their capital investments.

Areas of Expertise:

- Allocation of purchase price
- Asset depreciation studies
- Bankruptcy proceedings
- Charitable donations
- Commercial properties
- Condemnation
- Contamination impact studies
- ESOP/ESOT
- Estate planning
- Feasibility analyses
- General and limited partnership interests
- Gift tax evaluations
- Going public or private
- Highest and best use studies
- Industrial properties
- Insurance indemnification
- Intangible asset valuation
- Internal management decisions
- Investment counseling
- Land development cost studies
- Lease and rental analyses
- Lost profit analyses
- Marriage dissolution
- Mortgage financing
- Multi-family residential properties
- Municipal redevelopment studies
- Potential sales and purchases
- Railroad right-of-ways
- Special assessment appeals
- Special purpose real estate
- Tax abatement proceedings
- Tax increment financing
- Utility and communication easements

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