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Opportunities Amid Uncertainty

by **Nicholas J. Heinz, ASA**

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Opportunities Amid Uncertainty

2010 May Be the Time to Act on Important Strategic Business Decisions

by **Nicholas J. Heinz, ASA**

The 2010 year is a unique time to be making important business decisions, be they operating, financial, or ownership related. We are living in an uncertain world. Business owners must carefully consider the current uncertainties in order to position their companies (and themselves) optimally for the future. In this article, we focus on the current economic, transaction, and tax environments that business owners should consider in their decision-making.

THE ECONOMIC ENVIRONMENT

With very few exceptions, the operating environment across industries continues to be very challenging. The overall economy shrank around 2.5% during 2009 as measured by the change in GDP. While our economy appears to have avoided a doomsday scenario of continued, accelerated declines (at least to date), and GDP actually increased during the third and fourth quarter of 2009 (5.7% during quarter four based on the most recent official data available), we continue to see high levels of uncertainty regarding any recovery.

Through discussions with business owners and executives across all sorts of industries, we continue to hear the same two questions:

» Exactly how long will the economy take to normalize?
» What is the “new normal” that we are normalizing to?

For many industries, pre-2008 performance levels will likely not be achieved again in the short-term. Those management teams that understand the realities of the current economic environment will be the ones that will position their companies for both short-term and long-term success.

THE TRANSACTION ENVIRONMENT

In line with the general economic environment, merger and acquisition (“M&A”) activity during 2009 decreased substantially compared to the last several years. Based on broad market data published by *MergerStat*, total M&A transactions for 2009 measured 6,751, compared to totals of 10,559 and 8,048 for 2007 and 2008, respectively.

From an anecdotal perspective, our experience at Mercer Capital during 2009 suggests that the middle and lower ends of the M&A market were similarly diminished in 2009. Some deals did get done, but the overall quality of the companies being transacted was generally lower. As with the general economic activity, transaction activity did appear to show some signs of life, however meager, during the last quarter of 2009.

The reason for the reduced transaction activity is obvious. With the weak economic conditions (and general lack of capital availability), valuations have continued to decline relative to what might have been a reasonable valuation expectation just a few years ago. At these lower valuations, there are fewer sellers, especially sellers of quality companies.

As ownership groups make decisions regarding business transactions (either the sale of their business or the possible acquisition of other businesses), they must understand the market from just a few years ago is no longer directly relevant. The price that could have been gotten three years ago is not the appropriate benchmark from which to make investment decisions. Such a backward view of the market could result in a business owner missing a viable opportunity for liquidity; an opportunity that may be very attractive relative to what will be available in the future.

THE TAX ENVIRONMENT

Usually, the one part of the financial environment that is certain is taxes. While there is no question that there will continue to be a tax burden, the level and form of taxes is currently in flux. Consider the following:

» As of January 1, 2010, there is no estate tax. The 2001 tax bill which set a schedule to phase-out the estate tax has reached its final year. While expectations were that the estate tax issue would have been resolved for the long-term before this year, that did not happen. Currently, at least three scenarios seem possible:

  - An estate tax bill is passed during 2010, likely with compromises on the level of exemptions and rate, and made retroactive to January 1, 2010. There has been much discussion regarding the constitutionality of such a retroactive feature, so any bill with this feature would likely end up being debated in the court system for several years.

  - An estate tax bill is passed during 2010, again with compromises on the level of exemptions and rate, and is not made retroactive to the beginning of the year. This would create an almost arbitrary mid-year date upon which the tax will be changed.

  - No "new" estate tax bill is passed during 2010, meaning that the 2001 bill phases out and we return to the pre-2001 terms of the estate tax. This would result in much lower exemptions and a higher actual tax rate.

- In 2011, dividends, which are currently taxed at a federal rate of 15%, will revert to being taxed as ordinary income at an individual's highest marginal tax rate. At the same time, the tax rate applicable to capital gains will increase from 15% to 20%.

- Government expenditures currently far exceed government revenues and this is likely to continue well into the future. While a political discussion of spending and tax policy is not our intent, this is an important fact in considering what future tax burdens might be.

What will happen with the specific tax issues outlined above (not to mention the broader question of regular income tax rates) is not clear. There is likely to be an estate tax by 2011 (at the latest) and the rate on dividend and capital gains is likely to increase in the future.

Business owners must have flexibility in their ownership and liquidity plans to deal with the different possibilities.

CONCLUSION

We face several uncertainties in 2010. However, as the legendary coach John Wooden once said, "Do not let what you cannot do interfere with what you can do." We cannot predict the future, but we can look for opportunities amid the uncertainties in the current economic, transaction, and tax environments. If Mercer Capital can assist you, please contact us at 901.685.2120.

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Accounting Considerations in the Acquisition of a Failed Bank

by **Andrew K. Gibbs, CFA, CPA/ABV**

After completing an FDIC-assisted transaction, the acquirer faces the task of accounting for the transaction in accordance with FASB ASC 805, *Business Combinations* (formerly SFAS141R). ASC 805 requires the acquirer to record purchased loans at their fair value, or the amount that would be received upon the sale of the subject loans in a transaction between market participants. Given the credit deterioration evident in the loan portfolios of most failed banks, the book values and fair values of acquired loans may diverge to a material degree.

Deposit assumption transactions generally present no complex accounting or valuation issues. Demand and savings accounts are recorded at their book values, which equal fair value. The acquired time deposit portfolio may require a determination of fair value. Unlike a non-assisted transaction, however, acquirers in assisted transactions have the right to adjust the rates on time deposit accounts immediately upon the acquisition. These rate adjustments, along with any attendant deposit run-off, may require consideration in the fair value analysis. Lastly, although not recorded in some transactions, the acquirer may recognize a core deposit intangible asset. While the acquirer may agree upon a deposit premium with the FDIC (or agree that a premium is not appropriate), this premium may not be determinative of fair value, as the intent of fair value is to determine a price in an "orderly" transaction. An FDIC-assisted transaction may not meet the definition of an "orderly" transaction for purposes of determining fair value.

Assisted transactions whereby the acquirer obtains the failed bank's assets, including its loans, along with a loss-sharing agreement present a much more complicated series of valuation and accounting issues. The valuation and accounting issues can be grouped in two primary categories:

- Issues that arise upon recording the transaction at the acquisition date; and,
- Issues that arise in the post-acquisition accounting for the acquired assets.

Mercer Capital reviewed SEC filings of banks participating in loss-share transactions. From this review, there appears to be some diversity of practice as to the accounting for loss-share transactions. The following discussion, therefore, is general in nature. Banks participating in loss-share transactions are advised to seek guidance from their accounting firms as to the valuation and accounting issues raised by the transactions.

ACQUISITION DATE ISSUES

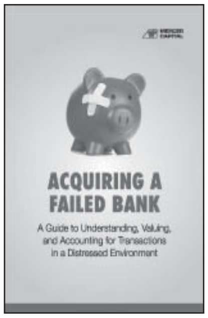
At the acquisition date, an acquirer would need to determine the fair value of the following assets:

- The loan portfolio, inclusive of consideration of the credit risk associated with the portfolio;
- The loss-share agreement, for which the fair value is tied to the projected losses covered by the FDIC;
- The core deposit intangible asset related to the assumed deposits; and,
- The time deposit portfolio assumed in the transaction.

Based on the preceding determinations of fair value, the acquirer would then calculate the amount of goodwill or negative goodwill. While goodwill is recorded as an asset on the balance sheet, negative goodwill results in a gain to the acquirer in the period surrounding the acquisition (included in non-interest income).

To demonstrate the preceding accounting and valuation issues, consider the following hypothetical transaction:

- An acquirer enters into a loss-share agreement with the FDIC regarding a failed bank with assets at book value of $1,000 and liabilities of $1,000. The acquirer agrees to purchase these assets for a discount of 15%.
- The acquired loan portfolio has a stated interest rate of 5% and amortizes over a three year term to maturity.
- After reviewing the loans, the acquirer estimates that loan losses of 10% on the remaining outstanding principal balance will occur in each of the three years remaining to maturity of the loans.



Excerpted from Mercer Capital's new book,

ACQUIRING A FAILED BANK

A Guide to Understanding, Valuing, and Accounting for Transactions in a Distressed Environment

See www.mercercapital.com for more information

Based on the preceding, Figure One amortizes the acquired loans:

Portfolio Amortization

	Beginning Portfolio Balance	Defaulted Principal	Performing Portfolio	Interest	Principal	Ending Portfolio Balance
Beginning Portfolio						$1,000
Year 1	1,000	(100)	900	45	285	615
Year 2	615	(61)	553	28	270	283
Year 3	283	(28)	255	13	255	0
Total		**($190)**		**$85**	**$810**	

FIGURE ONE

After determining the expected cash flows from the portfolio, the acquirer can then determine the fair value of the acquired loans. Because credit spreads have widened since origination of the loans, and to reflect the risk of adverse deterioration in default rates, the acquirer estimates that an 8% discount rate is appropriate.

Figure Two then illustrates the determination of fair value of the acquired loan portfolio:

Valuation Analysis - Loans

		Year 1	Year 2	Year 3
Principal Cash Flow		285	270	255
Interest Cash Flow		45	28	13
Total Cash Flow		$330	$297	$268
Periods Discounted		1	2	3
Discount Factors @	8.00%	0.9259	0.8573	0.7938
Discounted Cash Flow		**$306**	**$255**	**$212**
Sum of the Cash Flows		**$773**		

FIGURE TWO

The acquirer would thus record the acquired loan portfolio at its fair value of $773. Next, the acquirer would determine the fair value of the loss-share agreement, based on the projected loan losses and the loss coverage percentage agreed upon with the FDIC. The valuation of the loss-share agreement generally assumes a lower

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Our banking clients range from new bank charters to multi-billion dollar (assets) bank holding companies. We have worked for numerous governmental agencies, including the IRS, the FDIC, the SBA, the U.S. Attorney General's Office, and the Attorney General of the State of Tennessee. Our work has been reviewed and accepted by the major agencies of the federal government, including the SEC, the FDIC, the Federal Reserve, the Office of Thrift Supervision, and the OCC. Our work has also been reviewed by the largest accounting firms in the nation in connection with transactions involving their clients.

Our services are organized as follows:

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- » Employee Stock Ownership Plan Valuation
- » Tax Compliance Valuation
- » Strategic Analysis of Alternatives to Enhance Shareholder Value
- » Financial Advisor to Independent Board Committees

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discount rate than the determination of fair value of the loan portfolio, given the relative assurance of collection of amounts due under the loss-share agreement from the FDIC. Figure Three shows this calculation.

Valuation Analysis - Loss Share

		Year 1	Year 2	Year 3
Projected Losses		100	61	28
x Coverage Percentage		80.0%	80.0%	80.0%
Total Cash Flow		$80	$49	$23
Periods Discounted		1	2	3
Discount Factors @	3.00%	0.9709	0.9426	0.9151
Discounted Cash Flow		**$78**	**$46**	**$21**
Sum of the Cash Flows		**$145**		

FIGURE THREE

Based on the preceding determinations of fair value, and assuming the fair value of the liabilities equals book value, Figure Four indicates the assets and liabilities acquired in the transaction.

Net Assets Acquired

Cash	$150	<> *loan discount agreed upon with FDIC*
Loans	773	<> *per fair value analysis*
Loss Share Agreement	145	<> *per fair value analysis*
Total Assets Acquired	**$1,068**	
Deposits Assumed	$1,000	<> *assumed equal to fair value*
Net Assets Acquired	**$68**	

FIGURE FOUR

In the transaction, the acquirer received $1,068 of assets at fair value and assumed $1,000 of liabilities. To balance its books, therefore, the acquirer would need to need to record "negative goodwill" of $68; however, negative goodwill is not recorded as a "negative" asset. Instead, ASC 805 indicates that the acquirer should record a gain equal to the amount of negative goodwill.

POST-ACQUISITION DATE ISSUES

In many instances, due to the volume of problem assets, the magnitude of the fair value adjustments to the loan portfolio, and the need to track the loss-share asset, the post-acquisition accounting for the acquired loans is more complicated than the acquisition-date accounting. The primary ongoing accounting issues faced by the acquiring bank include the following:

» Estimating the accretion of the loan portfolio discount and the carrying value of the loan portfolio; and,

» Estimating the accretion of the loss share agreement and the carrying value of the loss-share agreement.

Figure Five rolls the loan portfolio balance forward from the acquisition date starting with the beginning fair value of the portfolio ($773).

In each period, the bank collects principal and interest payments on the portfolio, per the amortization of the portfolio in Figure One. In addition, the bank determined the fair value of the portfolio based on the return required by market participants at the valuation date (8%), which exceeded the stated note rate on the portfolio (5%). This disparity results in an additional loan discount accretion.

For example, in year 1, at an 8% interest rate, the portfolio would yield income of $62 ($773 x 8%). However, the bank collects interest of only $45 from borrowers. The $17 difference between the market yield and the note rate is accreted into income by the acquiring bank. The ending portfolio balance therefore equals the beginning portfolio balance ($773), minus principal collections ($285), plus the discount accretion ($17). Figure Six shows the roll-forward of the loss-share asset.

As indicated in Figure Six, the loss-share asset declines as the FDIC remits payments against covered losses. In addition, the fair value of the loss-share agreement was determined based upon an assumed 3% discount rate. As for the loans, this 3% return is accreted into income. Figure Seven summarizes the interest collected and accreted on the loan portfolio and loss-share asset.

In sum, the acquiring bank's interest income from the acquired loans would consist of three sources – the interest paid by the borrowers, the discount accretion on the loans, and the accretion of interest on the loss-share agreement. Overall, the acquiring bank would earn an effective yield of approximately 7.25% to 7.50% on the assets acquired, versus the actual note rate of 5%.

Loan Portfolio Roll-Forward

	Beginning Portfolio Balance	Interest @ Discount Rate	Cash Interest	Accretion of Loan Discount	Principal Collections	Ending Portfolio Balance
Beginning Portfolio						$773
Year 1	773	62	45	17	285	505
Year 2	505	40	28	13	270	248
Year 3	248	20	13	7	255	0
Total		**$122**	**$85**	**$37**	**$810**	

FIGURE FIVE

Loss Share Roll-Forward

	Beginning Balance	Interest @ Discount Rate	Collections from FDIC	Ending Balance
Beginning Portfolio				$145
Year 1	145	4	80	69
Year 2	69	2	49	22
Year 3	22	1	23	0
Total		$7	$152	

FIGURE SIX

Interest Income

	Cash Interest Paid	Loan Discount Accretion	Interest on Loss Share	Total Interest Income
Year 1	45	17	4	66
Year 2	28	13	2	42
Year 3	13	7	1	20
Total	$85	$37	$7	

Yield Analysis

	Total Interest Income	Loan Portfolio	Loss Share Asset	Implied Yield
Year 1	66	$773	$145	7.21%
Year 2	42	$505	$69	7.40%
Year 3	20	$248	$22	7.59%

FIGURE SEVEN

CONCLUSION

The preceding analysis, while still complex, is greatly simplified from real world practice. In reality, acquirers are faced with many challenging issues, such as:

» How should the acquirer consider credit deterioration in the determination of the fair value of the loan portfolio, particularly when weak underwriting or servicing lead to great uncertainty as to future credit losses?

» What adjustments are necessary when the actual cash flows from the portfolio differ from the projected cash flows? The preceding analysis made the greatly simplifying assumption that cash flows occur as originally anticipated. In reality, as actual cash flows differ from expected cash flows, the acquirer may need to adjust the loan discount accretion, the loss-share asset, and perhaps even establish a loan loss reserve when anticipated cash flows are lower than initially expected.

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Fair Value for **Impairment Testing**

Excerpted from Mercer Capital's upcoming book, ***Valuation for Impairment Testing, Second Edition***

STANDARD OF VALUE

Every valuation assignment begins by determining the appropriate definition, or *standard*, of value. The standard of value provides guidance about how, and from what perspective, value should be determined. The appropriate standard of value for most financial reporting valuation assignments, including impairment testing, is fair value, as defined in FASB ASC 820, *Fair Value Measurements and Disclosures* (ASC 820).

Fair value is defined in the glossary of ASC 820 as: "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value assumes a hypothetical transaction for the subject asset or liability at the measurement date. ASC 820 provides additional clarification related to the nature of this hypothetical transaction, which we have summarized below.

Market Exposure

ASC 820 explicitly states that fair value assumes exposure to the relevant market for a sufficient period of time for normal marketing activities. The hypothetical transaction is not a forced liquidation or distressed sale; however, it does reflect prevailing market conditions (ASC 820-10-35-51 E and G).

Exit Price

Fair value is measured from the perspective of the owner of the asset. In other words, it is measured as the price that would be received to sell an asset (exit price) rather than the price that would be paid to acquire an asset (entry price). In the context of measuring the fair value of a reporting unit for impairment testing, exit and entry prices are often indistinguishable.

Relevant Market

According to ASC 820, the hypothetical transaction occurs in the "principal market" for the asset – or if there is no principal market for the asset, the "most advantageous market" for the asset. The principal market is defined as "the market in which the reporting entity would sell the asset... with the greatest volume and level of activity..." (ASC 820, Glossary). In the context of ASC 350, there is generally no principal market for reporting units (or intangible assets); unlike securities, reporting units are not homogenous assets with active markets. So what is the most advantageous market?

The most advantageous market is defined as "the market in which the reporting entity would sell the asset... with the price that maximizes the amount that would be received for the asset... considering transaction costs in the respective markets" (ASC 820, Glossary). Depending on the circumstances surrounding a particular situation, the most advantageous market for a reporting unit could be the market made up of strategic buyers or the market made up of financial buyers. In any case, the most advantageous market will be ultimately defined by the market participants that make up the market, as we will discuss later.

While transaction costs should be *included* in the consideration of the most advantageous market for the given asset, these costs must be *excluded* from the fair value measurement itself. Transaction costs are an attribute of a market rather than the subject asset itself, and as such, they do not constitute a component of the "price that would be received" (ASC 820, Glossary).

Market Participants

Fair value is defined from the perspective of market participants rather than a specific party, such as the reporting entity. A market participant is defined as 1) an unrelated party, 2) knowledgeable of the subject asset, 3) able to transact, and 4) motivated but not compelled to transact (ASC 820, Glossary). In the context of the most advantageous market, potential market participants could be existing industry players, companies looking to enter the industry, private equity investors, or other parties.

ASC 820 clarifies that it is not necessary to identify specific market participants, but rather the characteristics that distinguish market participants in the given situation should be identified (ASC 820-10-35-9). For example, private equity investors generally rely on different funding sources than large operating companies; this is a distinguishing characteristic that would be relevant in the context of fair value.

Fair value is determined with reference to the assumptions market participants would use in valuing the subject asset or liability; assumptions used by the reporting entity may not be consistent with those made by market participants.

Highest & Best Use

Fair value also assumes that an asset will be employed in its highest and best use by market participants. Highest and best use is defined in ASC 820 as the use that would maximize the value of the asset or group of assets within which the subject asset would be used. Fair value should be determined based on the hypothetical transaction price assuming that the asset would be used within the "highest and best use" asset group, and that the other assets in that group would be available to market participants. If an asset is most valuable outside the context of any other assets, the fair value should be measured based on a hypothetical transaction of the asset on a stand-alone basis (ASC 820-10-35-10 through 820-10-35-14).

For reporting units, the use of an "in-use" or "in-exchange" valuation premise is not often controversial. The delineation of the likely market participants is often more significant in determining the degree to which synergies with potentially complementary businesses ought to be reflected in the fair value measurement.

VALUATION TECHNIQUES & INPUTS

Having discussed the definition of value pertinent to goodwill impairment testing, we will introduce some foundational valuation concepts in the following sections.

Approaches to Value

Generally accepted valuation theory (as well as ASC 820) recognizes three general approaches to valuation (American Society of Appraisers, *ASA Business Valuation Standards©* (Revision published July, 2008 and ASC 820-10-35-28). Within each approach, a variety of valuation methods (or techniques) can be applied to fair value measurement in a given

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situation. ASC 820 states that valuation techniques consistent with these approaches should be used to measure fair value.

» The **market approach** uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business) to determine value. Market methods include a variety of methods that compare the subject with transactions involving similar investments, including publicly traded guideline companies and sales involving controlling interests in public or private guideline companies. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

» The **income approach** includes valuation methods that convert a stream of expected future economic benefits into a single present value. Valuation methods under the income approach include variations of two techniques: single-period capitalization and discounted cash flow analysis. Option pricing models can also be used under the income approach in certain situations.

» The **cost approach** is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. In the context of a business, the cost approach is often described as an asset-based approach under which value is measured with reference to the values of the individual assets and liabilities of the reporting unit.

In the context of measuring the fair value of a reporting unit for purposes of goodwill impairment testing, valuation techniques under the market and income approaches are generally most appropriate. Valuation techniques under the cost approach frequently do not capture the value of goodwill and certain other intangible assets; in such cases, the resulting valuation indications would not be consistent with the objective of measuring fair value.

Fair Value Input Hierarchy

Inputs to the various valuation techniques may be either observable or unobservable. ASC 820 establishes a hierarchy which prioritizes inputs into three broad levels:

» Level 1 inputs are observable quoted prices in active markets for identical assets;

» Level 2 inputs generally include observable quoted prices for similar assets in active markets or quoted prices for identical assets in markets that are not active; and,

» Level 3 inputs are unobservable inputs that are developed based upon the best information available under the circumstances, which might include the reporting entity's own data.

Fair value measurements should rely on the highest level inputs available. ASC 820 notes that the availability of inputs can impact the selection of valuation techniques, but clarifies that the hierarchy prioritizes valuation inputs, not techniques (ASC 820-10-35-38).

Fair value measurements for impairment testing tend to rely heavily on Level 3 inputs, but can also include Level 2 inputs. Common inputs include:

» Projected financial performance for a reporting unit (Level 3) ;

» Market pricing information for publicly traded guideline companies (Level 2);

» Pricing information for recent control transactions in similar businesses (Level 3);

» Cost of capital estimates (Level 2 or Level 3);

» Other inputs

By their nature, unobservable inputs cannot be derived from external market information. Accordingly, unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (ASC 820-10-35-53).

Legislation Update:
Grantor Retained Annuity Trusts

by **Francis O. Lynch**

In 2008, we described the "perfect storm" of conditions existing at the time that increased the likelihood of success for a grantor retained annuity trust ("GRAT"). Although much has changed since 2008, most of the circumstances promoting the consideration of a GRAT still prevail. The "perfect storm" will likely be stilled if the Senate passes a pending bill. The legislation, called the *Small Business and Infrastructure Jobs Tax Act of 2010* (HR 4849), was passed by the House of Representatives on March 24, 2010.

Lawmakers designed the bill to provide incentives for small business and infrastructure job creation, but such incentives require "Revenue Provisions" necessary to offset spending and tax cuts. Section 307 of the bill acts as one of those revenue generators by expanding the rules on GRATs, which in turn increases the transfer tax income to the federal government. The Congress Joint Committee on Taxation estimates that $4.45 billion in revenue will be generated over ten years by this provision.

HOW DOES A GRAT TRANSFER WEALTH?

Under certain conditions, a GRAT can result in the transfer of wealth to family members without gift tax. First, a quick overview of how GRATs work. The grantor transfers assets into an irrevocable trust, which is established for a set term, and an annuity is paid back to the grantor during each year of that term. For gift tax assessment, the IRS assumes an expected level of asset appreciation, called the Section 7520 rate. The amount of the taxable gift is the fair market value of the property when it is transferred to the trust less the present value of the grantor's annuity interest, using the Section 7520 rate as the discount rate. This difference is often referred to as the remainder interest.

Figure One shows a five-year GRAT with the annuity set up such that the remainder interest equals zero, assuming $10 million of assets are placed into the trust with a Section 7520 rate of 3.4%.

	Year 1	Year 2	Year 3	Year 4	Year 5
Annuity Payments (in millions)	$1.5	$1.8	$2.2	$2.6	$3.1
Value of Assets Transferred to Trust	10		3.40% = Section 7520 Rate		
- Present Value of Annuity @ 3.4%	(10)				
Remainder Interest	**$0**				

FIGURE ONE

In order for the strategy to be successful, a portion of the assets transferred must remain in the trust after the satisfaction of the annuity. For this to occur, the return on the assets must exceed the section 7520 rate and the grantor must survive the term of the trust. If the return on assets does not exceed the 7520 rate, the assets will return to the grantor. If the grantor dies prior to expiration of the term, all assets remaining in the GRAT become a part of his or her estate. Therefore, current law limits downside risk of GRATs to wasted legal and administrative fees.

Figure Two displays the potential cumulative transfer of assets through the five year GRAT from Figure One, assuming the $10 million of assets grow at an annual rate of 10.0% after the formation of the GRAT.

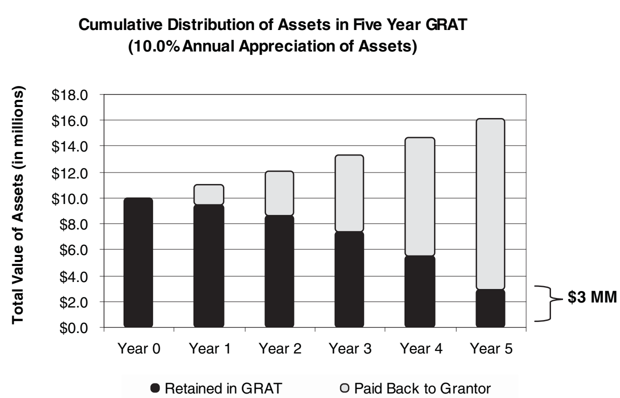


FIGURE TWO

At year five, approximately $3 million dollars of appreciated assets remain in the trust. If the grantor survives the five year term, that portion of wealth passes to the beneficiary free of transfer tax. In this example, 18.1% of the assets placed into the GRAT are transferred to the beneficiary free of tax.

The portion of assets shifted to the beneficiary depends on the spread between the actual return on the asset contributed to the trust and the 7520 rate. If these rates are equal, no assets are transferred through the GRAT to the beneficiary. If we assume that the assets will grow at 15.0% in the previous example, 28.8% of wealth is transferred through the trust. In short, this strategy can benefit those planning to gift appreciating assets.

NEW LEGISLATION

As mentioned earlier, the current law may have a short life. Section 307 of the pending legislation imposes two major additional requirements on GRATs: (1) the term must be no less than ten years and (2) the remainder interest must have a value greater than zero at the time of the transfer. Thus, as the new bill is currently written, the "mortality risk" of the grantor increases and the taxable gift must be greater than zero. The Senate Committee on Finance may suggest a minimum remainder interest such that a minimum taxable gift amount must be transferred, increasing the downside risk of the strategy. If such an amendment is added and the assets in a GRAT fail to appreciate at a rate greater than the 7520 rate, then the grantor will have paid unnecessary taxes in addition to administrative fees. If the bill remains unchanged from its current form, the positive taxable gift requirement is open to interpretation: could the gift value be $0.01?

THE "PERFECT STORM" CONTINUES

In 2008, we discussed three conditions that provided a "perfect storm" for GRATs: (1) a low section 7520 rate, (2) depressed asset values in most markets, and (3) the uncertainty of GRAT restricting legislation.

1. A low IRS 7520 rate increases the probability that the return on contributed assets will exceed the 7520 rate over the term of the GRAT, resulting in a transfer of wealth to the beneficiary without a transfer tax. A low 7520 rate also increases the expected portion of assets that could be passed to a family member by means of a GRAT. The 7520 rate is currently 3.4%. Although the rate was as low as 2.0% during part of 2009, the rate was recently as high as 6.2% in August 2007. Many wealthy individuals are setting up GRATs to lock in this lower rate.

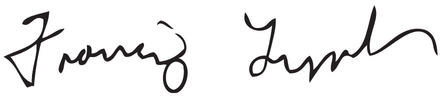
2. The S&P 500 has rebounded from 2009 lows, but the value of other assets (privately held companies and other real estate) may not have yet climbed back to pre-recession levels. Realizing a return in excess of the 7520 rate is more likely when starting from a lower base value. Thus, the expected portion of assets passed to a family member increases with relatively lower initial values.

3. GRAT restricting legislation is much more certain today than in 2008. As mentioned earlier, the potential effects of the pending legislation may increase the "mortality risk" and other downside risk of a GRAT. The Senate Committee on Finance may require a minimum amount of a taxable gift when establishing a GRAT. If not, interpretation of the "greater than zero" requirement may be supplied by the IRS.

TIME TO TAKE ACTION

If the GRAT strategy meets a potential grantor's objectives, now may be the time to take swift action.

GRATs are frequently formed using shares or interests in closely-held corporations, or family limited partnerships, and it is necessary to obtain an appraisal of these shares or interests to set the initial fair market value transferred to the GRAT. If the pending legislation is seen as the beginning of an era of increased scrutiny, grantors and beneficiaries will benefit from hiring experienced valuation firms they can trust to appraise the assets placed into their GRATs. As one of the country's premier business valuation firms, Mercer Capital has vast experience valuing corporations and partnerships. In addition, we can also value GRATs and provide other GRAT valuation consulting. Feel free to give us a call today at 901.685.2120 if we can help you or your client.



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MERCER CAPITAL
HIGHLIGHTS

Mercer Capital's professionals are actively engaged in thought leadership through various speaking engagements, published articles, and more.

ADDITIONS TO OUR STAFF

Chaya C. Glendon has joined the Mercer Capital professional staff as a Financial Analyst. Mrs. Glendon holds a Bachelor of Arts from Elon University, as well as a Masters of Finance from Vanderbilt University.

In her capacity as a Financial Analyst at Mercer Capital, Mrs. Glendon will provide business valuation and financial consulting services to a broad range of companies and financial institutions across the nation.

MERCER CAPITAL PROVIDES TRANSACTION ADVISORY SERVICES TO INMAN CONSTRUCTION CORP. IN ACQUISITION BY EMJ CORP.

When the shareholders of Memphis-based construction company Inman Construction Corp. began investigating their liquidity options, president Page Inman didn't take long to call on the services of Mercer Capital.

"I know (Mercer Capital CEO) **Chris Mercer** from church. When I found out what they did and how well-respected they were, I knew they'd be beneficial," said Inman.

Mercer Capital played a pivotal role as transaction advisor to Inman Construction Corp. in its acquisition by Chattanooga-based EMJ Corp., which was made official on March 1, 2010.

"Mercer Capital did a fantastic job walking us through and protecting our interests. I think that's important, to not do it alone and get a well-respected firm to help you throughout the process," said Inman. "Mercer Capital can do everything from valuing a firm to acquisitions and mergers. They served as our advocate. With something that is as big as selling your company, I think there are too many pitfalls for any one person to know them all. Getting professional help pays dividends."

"Inman Construction is a forward-thinking company," said Mercer Capital's **Nick Heinz**, who worked closely with management throughout the two-year process. "Many business owners don't think about their exit strategies until it's too late. By understanding what options were out there in the market for the company, Inman was well-positioned to explore this opportunity."

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April 15, 2010
"Rebuilding the Economic Value of Your Business"
Family Business Magazine Conference
Sponsored by the Stetson University Family Enterprise Center
Celebration, Florida
Z. Christopher Mercer, ASA, CFA, ABAR

April 17, 2010
"Buy-Sell Agreements"
ACTEC Regional Meeting
Knoxville, Tennessee
Z. Christopher Mercer, ASA, CFA, ABAR

May 7, 2010
"Subsequent Events After the Valuation Date"
AICPA/AAML 2010 National Divorce Conference
Las Vegas, Nevada
Z. Christopher Mercer, ASA, CFA, ABAR

May 7, 2010
"Attorney Tricks/Witness Traps: The Litigation Wars"
AICPA/AAML 2010 National Divorce Conference
Las Vegas, Nevada
Z. Christopher Mercer, ASA, CFA, ABAR and Jeffrey Brend, JD, CPA/ABV, ASA, CFE, AAML

May 13, 2010
Hawaii CFA Society
Honolulu, Hawaii
Travis W. Harms, CFA, CPA/ABV

June 3, 2010
"Marketability Discounts and Business Valuation Standards"
NACVA/IBA 2010 Annual Consultants' Conference
Miami Beach, Florida
Z. Christopher Mercer, ASA, CFA, ABAR

To book a speaker for your next meeting, contact Barbara Walters Price at 901.685.2120 or priceb@mercercapital.com.

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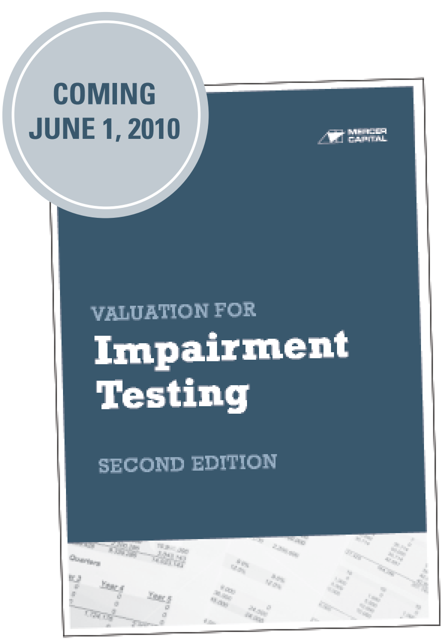

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