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# Valuation Perspectives

*"Your Valuation Solution"*

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## S Corp Assumptions Worthy of Challenge

The S corp models make certain assumptions without regard to whether or not those assumptions are true. The first assumption is that all public stock market participants fully pay dividend and capital gains taxes. The second assumption is that the taxes that investors pay directly correlates with value.

Extensive academic research shows neither of these assumptions is true, for many reasons. This means that the models that are currently used likely overstate the impact of taxes on market returns. There really isn't a simple model to handle this issue, as much as the business valuation profession would like one; unfortunately, the capital markets don't make it that easy.

Just as the effects of size and liquidity are "baked into" market returns, so, too, are tax effects. What valuation experts are trying to do when valuing a pass-through entity is to remove the extent that dividend and capital gains taxes affect the value of an investment and therefore, the market returns that experts use to value companies. The best place to remove the effect is from the market return itself, as opposed to the fairly convoluted cash flow models previously used. This should be familiar to experts because they already adjust market returns for size and liquidity.

When valuing a pass-through entity, valuators need to deduct taxes on corporate income (whether paid at individual or corporate level) because academic research shows that all taxes affect value and therefore, market returns. Once income taxes are deducted and the valuator has a desired level of net cash flow, then the expert makes an adjustment to the market return applied to the cash flow—again, similar to the adjustment for size and liquidity.

Everybody wants to know: How much do you adjust the market return? Therein lies the rub. Some of the research on this topic has specific methodology for testing the magnitude of dividend and capital gains taxes in market returns and further, the extent that those taxes affect value. One possibility is an adjustment done by reducing the market return (which in effect, increases the value). One can calculate the value with and without the adjustment to the market return to get an order of magnitude that the adjustment has made. To put an adjustment in context, many models put a "cap" on the magnitude of the adjustment of about 25%. Again, this magnitude of adjustment assumes all investors are fully taxable and further assumes that the fact they are taxable directly correlates with value. Neither assumption is true; thus, the magnitude of any adjustment should be less, and quite possibly significantly so.

*Based on an interview with Nancy Fannon, owner of Fannon Valuation Group, on the publication of a paper she wrote with Professor Keith Sellers at the University of Denver titled "Valuation of Pass-Through Entities: Looking at the Bigger Picture." The paper was recently ranked among the top 10 SSRN downloads.*

## Can Your Enthusiasm Hurt Your Case in the Delaware Chancery Court?

Being passionate about your work is a good thing, of course, but can that enthusiasm hurt valuation experts if they bring it into court? When is the line crossed between independence and advocacy?

Experts don't have to be shrinking violets, but they detract from their usefulness when they are looking for ways to help the attorney win the case, says Vice Chancellor Donald F. Parsons Jr. of the Delaware Court of Chancery. Parsons isn't troubled if experts stick to their bailiwick, even if they do so with vehemence. The trouble is when the experts become members of the legal team and start coming across as yet another agent for the plaintiff or defendant.

Kevin Shannon, a partner at Potter, Anderson & Corroon LLP, agrees. He thinks there's no problem with an enthusiastic expert, assuming he or she is

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reasonable and well-supported in his or her position. The line gets crossed when experts take unreasonable positions, such as saying to the client, "Look how high I can get your damages."

To avoid being too partisan, Parsons suggests that experts should have a healthy skepticism about the case-related information the party supplies them. That doesn't mean doubting the documents provided. But if something sounds a little unusual or surprising, the expert should question it. Experts cannot appear spoon-fed and unwilling to probe a little bit deeper into the material if necessary.

The real risk for experts is to lose credibility, as Shannon points out. The court disregards unreliable testimony, so it is important that experts take positions that are grounded in existing finance theory and facts. Better for a client to have a sound number than go in with an exaggerated number that the court just disregards. When this occurs, the court focuses on the other side's experts and either makes some small changes or simply accepts his or her testimony.

## Economy May be Triggering Litigation in Every Public Deal

"Almost every acquisition of a large U.S. public company announced in 2010 or 2011 elicited multiple lawsuits," says report, *Recent Developments in Shareholder Litigation Involving Mergers and Acquisitions—March 2012 Update*. "Only a small fraction of these lawsuits, however, resulted in payments to shareholders," adds the report summary; "the majority settled for additional disclosures or, less frequently, changes in merger terms, such as deal protection provisions." Highlights of the 2012 M&A litigation update:

- In 2007, just about half (53%) of the deals valued at over $500 million attracted litigation; by 2011, almost all deals of that size (96%) spun off shareholder lawsuits.
- During that same time, the absolute count of lawsuits involving deals of less than $500 million also nearly doubled, with 289 cases filed in 2007 and 502 filed in 2011. The number of cases more than doubled, from 2.8 suits per deal in 2007 to 6.8 in 2011.
- Smaller deals weren't immune; from 2007 to 2011, 15 deals worth over $100 million drew 15 shareholder filings or more. Notably, 12 of these deals were announced in 2010-2011.
- Certain industries seem to attract more lawsuits—in particular energy (8.6 per deal) and consumer goods (6.0 per deal).

*A flight from Delaware?* Delaware courts continue to claim a greater share of the litigation, with case filings climbing from 34% of all shareholder suits in 2007 to 45% in 2011. At the same time, "the most striking trend in venue choice," the study says, is that while shareholders are challenging the same deal in Delaware, they are increasingly likely to file a suit based on the same facts and claims in California, New York, and Texas, "likely reflecting where many deal targets are headquartered."

## IVSC Issues New Guidelines on Fairness Opinions

"A valuation or valuation analysis is often at the core" of a fairness opinion, says the International Valuation Standards Council (IVSC) in a news release. Although some countries regulate the conditions surrounding fairness opinions—including who may provide them and what they should contain—these requirements "are not consistent," the IVSC says, "and many companies are domiciled in countries with no regulation at all." Further, because a typical fairness opinion contains more than valuation advice, they often fall outside of the International Valuation Standards and the related ethical framework.

To bridge this gap and to promote the key principles of "independence, objectivity, and transparency," the IVSC has just issued a new exposure draft of its Procedural Guidelines for Fairness Opinions. Download a copy of the draft at: http://www.ivsc.org/pubs.

## Are We Still Confused About Goodwill?

Courts across the U.S. still struggle to determine and divide goodwill in divorce cases—particularly in those jurisdictions that follow the majority rule and require making a distinction between personal goodwill (nondivisible) and enterprise goodwill (divisible). "Or is it the valuator who is confused?" asked presenters Sharyn Maggio (Maggio & Co.) and Miriam Mason (Mason Black & Caballero) at the recent AICPA/AAML National Conference on Divorce in Las Vegas.

Some appraisers might consider Maggio lucky; she practices in New Jersey, which does not recognize the distinction. "It's all divisible," Maggio said, "but I work with one practitioner who insists that with respect to a highly skilled professional, there is no goodwill: It's all personal." Other states' courts have agreed, relying on an inverse argument. For example, in a Missouri decision, the husband claimed he was a key employee in his seven-man roofing business, but the court declined to reduce its value by any personal goodwill, finding the husband didn't provide the highly skilled professional services that would qualify.

Some courts have determined that all professional goodwill must be salable to be divisible, as evidenced by a noncompete; still others preclude the appraiser from assuming the presence of a noncompete. Notably, in Gaskill v. Robbins (2009), the Kentucky Supreme Court held:

> *While fair market value of [the wife's practice] anticipates what a willing buyer would give a willing seller, the fictional sale must be viewed as a "fire sale," meaning that it must be valued in its existing state. This precludes factoring in a nonexistent non-compete clause, as there is no requirement that [the wife] enter into one other than as a possible negotiated term of a real sale.*

The Gaskill court also required that any goodwill value "must" have a rational basis in accounting principles and "should avoid speculation and assumptions as much as possible." This language is a "little disconcerting," Maggio said. BV appraisers have to make assumptions, particularly regarding goodwill. "But courts don't like it," she added, noting that Gaskill is a "must read" case, no matter where you practice. In fact, this year the case came up again after another trip through the courts, and the appeals court affirmed the previous decisions.

## Well-Planned FLP Survives IRS Challenge

***Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (March 19, 2012)**

It's hard to imagine a better set of facts supporting the formation, funding, and operation of a family limited partnership (FLP), yet still the IRS took issue. In 1990, a widow inherited her husband's quarry business plus additional real property and stock. Shortly thereafter, she executed a will leaving many of the specific assets to her three grown children, dividing the residual equally among them.

Some years later, when their mother was suffering from Alzheimer's, the three children (who all managed the family businesses in various capacities) agreed to divide their mother's estate equally and petitioned the probate court to become her co-guardians.

Three FLPs plus a corporate GP. An estate attorney advised the creation of three FLPs, one for the benefit of each grown child, plus a corporation to serve as general partner (GP) for all three. Each FLP would receive equal assets, while the mother would retain over $1.1 million in a separate guardianship account for her living expenses.

The corporate GP would also receive a "reasonable management" fee for its services, thus ensuring that the mother (who would own all the stock in the corporation) would receive "adequate income to cover [her] probable expenses for support, care, and maintenance for the remainder of [her] lifetime." Finally, they noted the plan should reduce estate taxes by nearly $3 million.

The probate court approved the plan in June 2003. In December 2003, the mother transferred equal values of stock and other property to the FLPs. Over the next three years, she gave partnership interests to the three children, with appropriate entries to her capital accounts. During the same time, the children maintained the properties and the accounts. They also met regularly as officers and directors of the corporate GP.

In 2005, the mother died. Her federal estate tax return reported her remaining ownership interests in the FLPs as well as her full (100%) ownership of the corporate GP. Three years later, the IRS assessed a deficiency of just over $2.2 million based on its determination that the full fair market value of the FLP assets should be included in the decedent's estate pursuant to IRC Sec. 2036(a). In response, her estate argued that the decedent's transfer of assets met the "bona fide sale" exception to Sec. 2036(a) because she had "legitimate and significant nontax reasons" for creating the FLPs and because she received partnership interests proportionate to the value of the transferred property.

Estate (but not tax) planning is paramount. The facts substantially supported the mother's position: including the mother's clear and primary concern to distribute her estate equally among her children; her legitimate concern about the management of the

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assets, which was undertaken by her children; and that she received appropriate partnership interests in the FLPs. Although the probate court petition mentions estate tax planning, the court held that "there is no evidence that tax savings motivated the defendant." Thus the value of the FLP transfers fell within the bona fide sale exception to Sec. 2036(a).

As a second argument, the IRS claimed the parties had an implied agreement that the decedent would continue to enjoy the income from the FLPs during her lifetime. The court rejected this argument, too.

The decedent had a bona fide purpose for creating the FLPs, and she had a bona fide purpose for creating the corporation to manage them. She also appropriately reported the full value of the corporation on her estate tax return. Based on all these facts, the court excluded the value of the FLPs from the decedent's gross estate.

## About Our Firm.................

Our firm has years of experience assisting attorneys and business owners in determining value for litigation support, gift and estate tax planning, marital dissolution, buy and sell agreements, and business sale purposes. Whether you are determining the fair market value of a closely held business interest for sale, gift, or estate planning, knowing what your company is worth is one of the most important financial aspects of being in business.

In addition, you may use a business valuation as a management and planning tool. Besides acting as a scorecard that will help management determine whether the company is gaining or losing value, the valuation provides a better understanding of the real profitability of the business. Whatever reason you have for needing a business valuation, John R. Janicek, CPA P.C. is prepared to assist you in being your valuation solution.



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