Valuation Issues

Dealmakers & Deal Breakers:
Coordinating Business and Estate Planning Goals
North Carolina Bar Association
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Business Valuation Disc

1. Hundreds of articles covering virtually every business valuation issue.
2. Key Revenue Rulings.
3. Key business valuation court cases.
4. Information needs checklists.
5. Entire chapters from the *CCH Business Valuation Guide*.
6. Comparison of business valuation accreditation and credentials.
7. Articles on how to effectively analyze and assess a business valuation report.

Overview of Presentation

1. Shareholder and Buy/Sell Agreements.
2. Tax-Affecting (C to S Conversions).
3. Contingent Assets and Liabilities.
4. Trapped-in Capital Gains.
5. Aggregation Issues.
6. Reasonable Compensation.
7. Critiquing a Valuation Report.
8. Current IRS Attacks on FLPs.

Shareholder and Buy/Sell Agreements

1. Purchase Price Clarity.

2. Impact of Buy/Sell Agreement on Estate Value.

Shareholder and Buy/Sell Agreements

Fair Market Value

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Fair Value

A judicially-determined value.

Shareholder and Buy/Sell Agreements

Lauder II Test

1. Offering price is fixed and determinable under the agreement.

2. Agreement was binding on the parties during life and after death.

3. Agreement was entered into for *bona fide* business reasons.

4. Agreement was not a substitute for a testamentary disposition.

Estate of Lauder v. Commissioner, T.C. Memo 1992-736

Tax-Affecting

C Corp		S Corp	
Pre-tax Income	$1,000,000	Pre-tax Income	$1,000,000
Less: 39% Corp Taxes	($390,000)	Less: 0% Corp Taxes	($0)
Company Net Income	$610,000	Company Net Income	$1,000,000
Less: 22% Indiv Taxes	($134,200)	Less: 40% Indiv Taxes	($400,000)
Net Proceeds to Owner	$475,800	Net Proceeds to Owner	$600,000
Total Taxes Paid	$524,2000	Total Taxes Paid	$400,000
Effective Total Tax Rate	52%	Effective Total Tax Rate	40%

Tax-Affecting

C Corp		S Corp	
Pre-tax Income	$1,000,000	Pre-tax Income	$1,000,000
Less: 39% Corp Taxes	($390,000)	Less: 0% Corp Taxes	($0)
Company Net Income	$610,000	Company Net Income	$1,000,000
Divide by: Cap Rate	÷ 20%	Divide by: Cap Rate	÷ 20%
Equals: Company Value	$3,050,000	Equals: Company Value	$5,000,000
		Increase in Company Value	64%

Tax-Affecting

1985	2003
0.7 million S Corps	3.3 million S Corps
2.4 million C Corps	2.1 million C Corps

Tax-Affecting

1. *Gross* case (2001) and others following initially created a strong precedent for not tax affecting. This line of cases is now widely rejected.

2. Recent tax-affecting models quantify the value of the S election. General agreement in the valuation community.

3. Existence of the "S Corp Premium" is supported by some studies analyzing actual transaction data for C and S corps.

4. Magnitude of "S Corp Premium" could change if tax rates change in the future.

Tax-Affecting

Factors to Consider:

1. Most likely buyer of the S Corp.
2. Likelihood that the S election will be broken.
3. Distribution levels.
4. Tax rates.

Contingent Assets/Liabilities

Environmental Liabilities

Lawsuits

Insurance Proceeds

Contingent Assets/Liabilities

Insurance Proceeds

Blount, 428 F.3d 1338 (11th Cir. 2005):

Value of life insurance proceeds receivable by corporation is offset by obligation to pay those proceeds to redeem stock.

Followed *Cartwright,* 183 F.3d 1034 (9th Cir. 1999).

Trapped-in Capital Gains

Asset in C Corp		Asset Owned Outright	
Land Value	$1,000,000	Land Value	$1,000,000
Less: Land Basis	($0)	Less: Land Basis	($1,000,000)
Equals: Capital Gain	$1,000,000	Equals: Capital Gain	$0
Less: 22% Taxes	($220,000)	Less: 22% Taxes	($0)
Net Value to Company	$780,000	Net Value to Owner	$1,000,000

Trapped-in Capital Gains

C Corps

Cases starting with *Davis* (1998) and *Eisenberg* (1998) continuing through *Dunn* (2002) and culminating with *Jelke* (2007) give increasing support for a dollar-for-dollar deduction for trapped in capital gains.

Trapped-in Capital Gains

S Corps, LLCs, Partnerships

Cases such as *Jones* (2001) and *Dailey* (2001) recognize a potential adjustment or discount for trapped in capital gains. One key issue focuses on the possibility or likelihood of taking a Section 754 election.

Aggregation Issues

For ESTATE TAX purposes, it is generally held that the owner of a controlling interest in an entity (i.e., Manager, GP, Voting Stock) must aggregate all interests owned (Non-Manager, LP, Non-Voting, etc.) and value the entire interest as controlling. See *Ahmanson*, 674 F.2d 761 (9th Cir. 1981) and *Curry*, 706 F.2d 1424 (7th Cir. 1983).

Aggregation Issues

Scenario 1		Scenario 2	
Dad	1% GP	Child 1	1% GP
Dad	69% LP	Dad	70% LP
Child 1	10% LP	Child 1	9% LP
Child 2	10% LP	Child 2	10% LP
Child 3	10% LP	Child 3	10% LP

Dad = 70% GP

Dad = 70% LP

Reasonable Compensation

Auto Dealer		Auto Dealer Adjusted	
Revenues	$10,000,000	Revenues	$10,000,000
All Expenses	($9,000,000)	All Expenses	($9,000,000)
Owner Comp	($1,000,000)	GM Comp	($200,000)
Equals: Net Profit	$0	Equals: Net Profit	$800,000
Divide by: Cap Rate	÷ 20%	Divide by: Cap Rate	÷ 20%
Equals: Company Value	$0	Equals: Co. Value	$4,000,000

Reasonable Compensation

Law Firm		Law Firm Adjusted	
Revenues	$1,000,000	Revenues	$1,000,000
All Expenses	($200,000)	All Expenses	($200,000)
Lawyer Comp	($800,000)	Lawyer Comp	($800,000)
Equals: Net Profit	$0	Equals: Net Profit	$0
Divide by: Cap Rate	÷ 20%	Divide by: Cap Rate	÷ 20%
Equals: Firm Value	$0	Equals: Firm Value	$0

Critiquing Valuation Reports- Top 20 Countdown of Problems

20. Plagiarism.

19. Mathematical errors.

18. Failure to adequately define and follow the appropriate standard of value.

17. Failure to cite and follow the accepted and appropriate business valuation standards.

16. Failure to visit the company and interview management.

Critiquing Valuation Reports

15. Disproportionate Company / Economy sections.

14. A "financial analysis" section that lacks analysis.

13. Reliance on number crunching only, including the use of valuation software programs.

12. Improper use and understanding of accepted business valuation methods.

11. Use of the excess earnings method.

Critiquing Valuation Reports

10. Cherry-picking or improper calculation of public company or transaction multiples.

9. Irrational or unsupportable assumptions.

8. Time travel.

7. Improper use and/or application of discounts or premiums for control and marketability.

6. Misrepresentation of qualifications and experience.

Critiquing Valuation Reports

5. Underlings who have no experience do all work.
4. Preliminary draft reports.
3. Failure to support the rationale for discounts and weightings.
2. Lack of analysis, detail, and inability to replicate results.
1. Advocacy.

Current IRS Attacks on FLPs

1. Bad Facts Cases.

2. Indirect Gift Theory.

   IRS: *Shepherd* (2000), *Jones* (2001), and *Senda* (2004)

   Taxpayer: *Holman* (2008) and *Bianca Gross* (2008)

3. “Passive” Assets: stocks and/or real estate.

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