Valuation Issues

Dealmakers & Deal Breakers:
Coordinating Business and Estate Planning Goals
North Carolina Bar Association
January 22, 2009

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Business Valuation Disc

2. Key Revenue Rulings.
3. Key business valuation court cases.
4. Information needs checklists.
5. Entire chapters from the *CCH Business Valuation Guide*.
7. Articles on how to effectively analyze and assess a business valuation report.

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Overview of Presentation

1. Shareholder and Buy/Sell Agreements.
2. Tax-Affecting (C to S Conversions).
5. Aggregation Issues.
6. Reasonable Compensation.
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.

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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

<table>
<thead>
<tr>
<th></th>
<th>C Corp</th>
<th>S Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax Income</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less: 39% Corp Taxes</td>
<td>($390,000)</td>
<td>Less: 0% Corp Taxes</td>
</tr>
<tr>
<td>Company Net Income</td>
<td>$610,000</td>
<td>Company Net Income</td>
</tr>
<tr>
<td>Less: 22% Indiv Taxes</td>
<td>($134,200)</td>
<td>Less: 40% Indiv Taxes</td>
</tr>
<tr>
<td>Net Proceeds to Owner</td>
<td>$475,800</td>
<td>Net Proceeds to Owner</td>
</tr>
<tr>
<td>Total Taxes Paid</td>
<td>$524,2000</td>
<td>Total Taxes Paid</td>
</tr>
<tr>
<td>Effective Total Tax Rate</td>
<td>52%</td>
<td>Effective Total Tax Rate</td>
</tr>
</tbody>
</table>

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# Tax-Affecting

<table>
<thead>
<tr>
<th></th>
<th><strong>C Corp</strong></th>
<th></th>
<th><strong>S Corp</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax Income</td>
<td>$1,000,000</td>
<td>Pre-tax Income</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Less: 39% Corp Taxes</td>
<td>($390,000)</td>
<td>Less: 0% Corp Taxes</td>
<td>($0)</td>
<td></td>
</tr>
<tr>
<td>Company Net Income</td>
<td>$610,000</td>
<td>Company Net Income</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Divide by: Cap Rate</td>
<td>÷ 20%</td>
<td>Divide by: Cap Rate</td>
<td>÷ 20%</td>
<td></td>
</tr>
<tr>
<td>Equals: Company Value</td>
<td>$3,050,000</td>
<td>Equals: Company Value</td>
<td>$5,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Increase in Company Value</td>
<td>64%</td>
<td></td>
</tr>
</tbody>
</table>

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## Tax-Affecting

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>S Corps</td>
<td>0.7 million</td>
<td>3.3 million</td>
</tr>
<tr>
<td>C Corps</td>
<td>2.4 million</td>
<td>2.1 million</td>
</tr>
</tbody>
</table>

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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

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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

<table>
<thead>
<tr>
<th>Asset in C Corp</th>
<th>Asset Owned Outright</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land Value</td>
<td>Land Value</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less: Land Basis</td>
<td>Less: Land Basis</td>
</tr>
<tr>
<td>($0)</td>
<td>($1,000,000)</td>
</tr>
<tr>
<td>Equals: Capital Gain</td>
<td>Equals: Capital Gain</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>Less: 22% Taxes</td>
<td>Less: 22% Taxes</td>
</tr>
<tr>
<td>($220,000)</td>
<td>($0)</td>
</tr>
<tr>
<td>Net Value to Company</td>
<td>Net Value to Owner</td>
</tr>
<tr>
<td>$780,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>
Trapped-in Capital Gains

C Corps

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

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dad 1% GP</td>
<td>Child 1 1% GP</td>
</tr>
<tr>
<td>Dad 69% LP</td>
<td>Dad 70% LP</td>
</tr>
<tr>
<td>Child 1 10% LP</td>
<td>Child 1 9% LP</td>
</tr>
<tr>
<td>Child 2 10% LP</td>
<td>Child 2 10% LP</td>
</tr>
<tr>
<td>Child 3 10% LP</td>
<td>Child 3 10% LP</td>
</tr>
<tr>
<td>Dad = 70% GP</td>
<td>Dad = 70% LP</td>
</tr>
</tbody>
</table>

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## Reasonable Compensation

<table>
<thead>
<tr>
<th></th>
<th>Auto Dealer</th>
<th>Auto Dealer Adjusted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$10,000,000</td>
<td>Revenues</td>
</tr>
<tr>
<td>All Expenses</td>
<td>($9,000,000)</td>
<td>All Expenses</td>
</tr>
<tr>
<td>Owner Comp</td>
<td>($1,000,000)</td>
<td>GM Comp</td>
</tr>
<tr>
<td><strong>Equals: Net Profit</strong></td>
<td><strong>$0</strong></td>
<td><strong>Equals: Net Profit</strong></td>
</tr>
<tr>
<td>Divide by: Cap Rate</td>
<td>▷ 20%</td>
<td>Divide by: Cap Rate</td>
</tr>
<tr>
<td><strong>Equals: Company Value</strong></td>
<td><strong>$0</strong></td>
<td><strong>Equals: Co. Value</strong></td>
</tr>
</tbody>
</table>

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## Reasonable Compensation

<table>
<thead>
<tr>
<th>Law Firm</th>
<th>Law Firm Adjusted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>All Expenses</td>
<td>($200,000)</td>
</tr>
<tr>
<td>Lawyer Comp</td>
<td>($800,000)</td>
</tr>
</tbody>
</table>

Equals: Net Profit $0

Divide by: Cap Rate $\div 20\%$

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.
15. Disproportionate Company / Economy sections.


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.

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.

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