

Viewpoint on Value



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John M. Leask II CPA, LLC.

Business Valuation Services

765 Post Road, Fairfield, Connecticut 06824

Phone: 203-255-3805 • Fax: 203-380-1289

E-mail: Mac@LeaskBV.Com • Web Page: www.LeaskBV.com

John M. Leask, II
(Mac)
CPA/ABV, CVA



Holding companies with built-in capital gains

Tax Court case addresses key valuation issues

The *Estate of Richmond* has been called a must-read case for valuation guidance in 2014. The IRS and taxpayer started out more than \$6.1 million apart. But the Tax Court slowly worked through the major sticking points — including how to select the appropriate valuation methodology and how to handle the company’s built-in capital gains tax liability — to arrive at a value substantially higher than was originally indicated on the estate tax return.

Appraisers narrow the value gap

When she died in December 2005, the decedent owned a 23.44% interest in PHC, a family-owned holding company with a net asset value of approximately \$52.1 million. The value of the interest per her estate tax return was approximately \$3.1 million, based on an unsigned draft appraisal report issued by PHC’s accountant. The IRS issued a deficiency notice that valued the estate’s PHC stock at \$9.2 million and assessed a valuation misstatement penalty.

By the time the parties appeared in Tax Court, both sides had hired business valuation experts. And the difference between their positions had narrowed to only about \$2.3 million.

Asset-based approach appropriate for holding companies

The estate’s expert valued the decedent’s interest in PHC at about \$5 million, using the capitalization of dividends method. The IRS’s expert valued it at \$7.3 million, using the net asset method.

The estate’s expert used a subset of the income approach to value PHC, because the company had consistently paid dividends over its 35-year history. In addition, nine PHC stock transactions had occurred from 1971 to 1993 that had been based on the capitalization of dividends method.

The IRS’s expert used the asset-based (or cost) approach, because PHC’s underlying assets were



largely publicly traded stocks, including Exxon Mobil, Merck & Co., General Electric Co. and Pfizer. The market values of these stocks could be readily ascertained on any date. According to the court opinion, publicly traded stock prices take into account the market’s judgment regarding each stock’s projected income stream.

The Tax Court opinion states: “In general, an asset-based method of valuation applies in the case of corporations that are essentially holding corporations, while an earnings-based method applies for corporations that are going concerns.”

Built-in capital gains tax liabilities addressed at the entity level

When a C corporation’s assets increase in value over time, the company becomes liable for capital gains tax,

but only upon the sale of the assets. PHC is a C corporation that would owe approximately \$18.1 million in built-in capital gains tax if it were sold. Both sides agreed that a hypothetical investor would factor in this liability when purchasing an interest in PHC.

When a C corporation's assets increase in value over time, the company becomes liable for capital gains tax.

The Tax Court rejected the estate's dollar-for-dollar adjustment for built-in capital gains tax, because a sale of PHC's assets wasn't imminent. It also rejected the IRS expert's approach, which added a 15% incremental discount for built-in capital gains tax into his discount for lack of marketability.

Instead, the court decided to apply an entity-level adjustment, rather than to increase the discount for lack of marketability. Assuming a holding period of 20 to 30 years, the Tax Court determined that the present value of the built-in capital gains tax liability was approximately \$7.8 million.

Substantial valuation misstatements are costly

A "substantial misstatement" occurs when the value reported on the estate tax return is 65% or less of the "correct" value, under Internal Revenue Code Section 6662. The penalty for a substantial misstatement is 20% of the amount by which your taxes are underpaid.

A "gross misstatement" occurs when a value reported on a tax return is 40% or less of the correct value. Gross misstatements result in a 40% penalty.

The minority, nonmarketable value of the estate's interest in PHC was \$3.1 million — less than half of the Tax Court finding of \$6.5 million. So, the estate qualifies for a 20% substantial valuation misstatement penalty. The Tax Court upheld the penalty because the value reported on the estate tax return was "essentially unexplained." The fact that the estate expert's value was included in an unsigned draft report was contrary to establishing a credible value.

Learn a lesson from *Richmond*

The estate wound up owing significantly more tax than it had originally planned. But *Richmond* wasn't a complete IRS victory. The Tax Court ruling represents a compromise between two widely divergent appraisal opinions. ●

Exception to misstatement penalties

The IRS allows an exception to its valuation misstatement penalties if a taxpayer can demonstrate that it acted with reasonable cause and in good faith. One way to prove you qualify for this exception is to hire a "qualified appraiser" to perform a "qualified appraisal."

A qualified appraiser has earned an appraisal designation from a recognized professional organization. It's also important for the expert to have appropriate education and experience in valuing the specific type of property.

A qualified appraisal report must:

- Be prepared, signed and dated by an independent qualified appraiser,
- Provide certain relevant information, such as a description of the property and its physical condition, the terms of any agreements that affect the property's value, the appraiser's identity and qualifications, the valuation date, and the methods and basis of valuation, and
- Not involve a "prohibited appraisal fee."

An example of a prohibited appraisal fee is one that's based on a percentage of the property's appraised value — or contingent on the outcome of an IRS investigation.

Choosing between lost profits and lost value

How do valuers quantify losses when breach of contract, patent infringement or other illegal acts damage a business? Three options exist: Calculate lost profits over a finite period, compute the decrease in business value or use a combination of both. What's appropriate depends on various factors, including relevant laws and the nature of the alleged wrongdoing.

Different situations require different solutions

The decision to quantify lost profits or lost business value (or both) depends on applicable federal or state law. For example, courts customarily limit damages in breach-of-contract cases to a plaintiff's lost profits during the contract term — even if the breach causes the plaintiff to go out of business.

The rationale is that, if the defendant hadn't breached the contract, it could have terminated the relationship at the end of the term, and the plaintiff would have lost the defendant's business anyway. A plaintiff might counter, however, that if the defendant hadn't ended the contract prematurely it would have had time to develop new business to replace the loss.



Most courts agree that, when a defendant's conduct destroys a business, the proper measure of damages is the business's fair market value on the date of loss. But in "slow death" cases, in which a defendant's conduct injures, and eventually kills, the plaintiff's business, both damages measures may come into play.

Calculating lost profits and lost business value often involves different sets of assumptions, leading to different results.

Double dipping is a potential hazard

Double dipping may occur when lost profits and lost business value damages relate to the same time period. The value of a business for a going concern is generally based on the future profits a hypothetical buyer can expect to earn. This is true regardless of the valuation method.

When the income approach is used, the relationship between profits and value is obvious. Under this approach, a valuator uses discounted cash flow or some other method to convert anticipated future earnings into a present value. Damages measurements for both lost profits and lost value focus on cash flow estimation and timing. They also take into account the risk associated with the probability of achieving a projected cash flow stream.

A company's anticipated future earnings are also considered when it's appraised using the market or cost approaches. For example, the market approach may derive value from a price-to-earnings or price-to-cash-flow multiple. Conversely, when the cost

approach is used to value a holding company, asset values may inherently take into account each asset's projected income, thus reflecting the company's anticipated future earnings.

Methods may generate conflicting results

Even when damages based on lost profits and lost business value overlap, the results of these two approaches won't necessarily be identical. In theory, when a defendant's conduct diminishes the value of a plaintiff's business, the difference between the "before" and "after" values may equal the present value of the plaintiff's lost profits on the valuation date.

But this seldom happens in practice. Calculating lost profits and lost business value often involves different sets of assumptions, leading to different results.

For example, a lost profits calculation may involve consideration of the plaintiff's specific tax situation

or other factors that cause it to earn more (or less) than a hypothetical investor. In addition, the valuator may reduce the business value for lack of marketability or liquidity — reductions that aren't generally applied in lost profits cases.

The role of hindsight is another potential difference between lost profits and lost value. Business value generally is based on facts known or reasonably knowable on the valuation date, regardless of what has transpired between that time and the trial date. But valutors sometimes consider subsequent events in determining the amount of lost profits.

Valuators bring clarity and support

There's more than one way to quantify economic damages in tort claims. Valuators bring clarity by helping attorneys decide on the appropriate measure of damages, calculating losses and reconciling differences between lost profits and lost business value claims. ●

Are shareholder advances bona fide debt or equity?

Closely held business owners sometimes need to advance their companies money to bridge a temporary downturn or provide extra cash flow for other purposes. How should valutors categorize those advances — as bona fide debt, additional paid-in capital or somewhere in between? The answer depends on the facts and circumstances of each assignment.

How advances affect value

How an appraiser classifies advances from shareholders has a direct impact on the value of equity. If an advance is classified as bona fide debt that must be repaid before debt owed to the bank or other creditors, the value of equity is lower than if it's classified as additional paid-in capital and treated as equity.

To illustrate, suppose a company has a shareholder "loan" on the books for \$200,000 and no other long-term debt. Also assume the fair market value of invested capital — long-term debt plus equity — is \$1 million.

If the advance is treated as equity, the value of the business is simply \$1 million, before discounts for lack of control and marketability. If the advance is treated as bona fide debt, the undiscounted value of the business is \$800,000 (\$1 million - \$200,000).

When shareholder advances matter

The proper classification of shareholder advances comes into play in divorce, bankruptcy, minority shareholder disputes and tax situations. Continuing



with the previous example, let's suppose the company is owned by one shareholder who is currently dissolving her marriage.

If the \$200,000 advance is treated as bona fide debt, her marital estate includes privately held stock and a receivable from the company. If not, the marital estate includes her stock, but no receivable. Initially, the classification of advances *seems* to have no net effect on the value of the marital estate. But this isn't necessarily true.

It's only a "wash" if *all* of the business interest is includable in the marital estate *and* no discounts are applied to the value of the business interest. The waters become even muddier when the subject company is owned by more than one shareholder or when advances are made by other related parties, such as a parent company or subsidiary.

How to classify advances

When deciding how to classify shareholder advances, valuers look to the economic substance of the transaction over its form. Some factors to consider when classifying these transactions include:

Intent to repay. Open-ended understandings between related parties about repayment imply that an advance is a form of equity. For example, an advance may be classified as a capital contribution if it was extended to save the business from imminent failure and no attempts at repayment have ever been made.

Loan terms. An advance is more likely to be treated as bona fide debt if the parties have signed a written promissory note that bears reasonable interest, has a fixed maturity date and a history of periodic loan repayments, and includes some form of collateral. If an advance is subordinate to bank debt and other creditors, it's more likely to qualify as equity, however.

Third party reporting. Consistently treating an advance as debt (or equity) on tax returns and CPA-prepared financial statements can provide additional insight into its proper classification.

Ability to repay. Other factors to consider when evaluating the nature of shareholder advances include the company's historic and future debt service capacity, as well as its credit standing and ability to secure other forms of financing.

The proper classification of shareholder advances comes into play in divorce, bankruptcy, minority shareholder disputes and tax situations.

When in doubt, some clients hedge their bets by requesting two valuation scenarios: one that treats shareholder advances as bona fide debt; the other as additional paid-in capital.

Who can help

Shareholder advances create appraisal challenges that can't be fixed with a one-size-fits-all solution. Valuation professionals evaluate many factors when deciding on the nature of these transactions. The "right" answer must be decided on a case-by-case basis. ●

The cost approach: An integral piece of the valuation puzzle

Numerous articles have been written about the nuances of the income and market approaches. But the cost approach can also be a viable valuation technique. The concept underlying the cost (or asset-based) approach is that the value of a business equals the difference between the values of its assets and liabilities. Here's a closer look at how it works.

Create a value-based balance sheet

Under the cost approach, appraisers identify all of the subject company's assets and liabilities. Next, they assign a value to each item, based on the appropriate standard of value. The book value of equity may not be a reasonable proxy of its fair market value for many reasons, however.

For example, assets are recorded at historic cost under Generally Accepted Accounting Principles (GAAP). Over time, historic cost may understate market value for appreciable assets, such as marketable securities and real estate.

In addition, some intangible assets — such as customer lists, brands and goodwill — are excluded from balance sheets prepared in accordance with GAAP, unless they were acquired from other companies. Balance sheets also might not include contingent liabilities, such as pending litigation or an IRS audit.

Companies that use cash- or tax-basis accounting methods present additional valuation challenges. Their balance sheets may exclude accruals (such as accounts receivable and payable) and rely on accelerated depreciation methods that understate the value of fixed assets.

This process results in the creation of a market-based balance sheet. Revaluing certain assets — such as machinery, equipment and real estate — may require separate appraisals.



Let common sense guide you

Courts often prefer the perceived simplicity of the cost approach, especially for asset holding companies and small manufacturers that rely heavily on their “hard” assets. It may also be used when the parties present conflicting appraisal evidence.

For example, in *Starling v. Starling*, the Virginia Court of Appeals opted for the cost approach when valuing a family-owned electrical contracting business. The court rejected the wife's appraisal, which derived value from future earnings and failed to adequately factor in business risks. Similarly, it disregarded the husband's appraisal, because it was far below the interest's liquidation value.

As *Starling* illustrates, the cost approach provides a useful “floor” for a company's value that serves as a sanity check for the other valuation approaches. After all, reasonable sellers typically won't accept less than net asset value in mergers or acquisitions, unless they're under duress to sell.

Remember the cost approach

Don't automatically overlook the cost approach in favor of more sophisticated market- and income-based techniques. It can provide straightforward — but valuable — insight into the value of a private business. ●



John M. Leask II CPA, LLC.

Business Valuation Services

765 Post Road, Fairfield, Connecticut 06824

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is Mac@LeaskBV.Com.

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 **John M. Leask II CPA, LLC.**
Business Valuation Services

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.