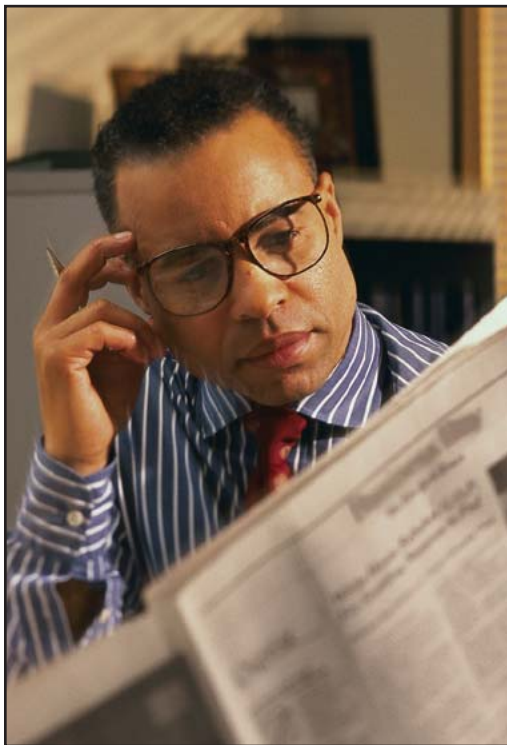


valuation outlook

BUSINESS VALUATION, FORENSIC ACCOUNTING AND LITIGATION NEWS OF SUBSTANCE

2007 and Beyond: What Are the Big Issues in Business Valuation?

The IRS' enhanced oversight of appraisals and appraisers is certainly a hot topic in 2007, along with the continued evolution of valuing pass-through entities (tax-affecting). Fair value for financial reporting and related FASB pronouncements will continue to make news, as will efforts by the BV profession to create a convergence of practice standards.



Tax issues heating up

Last year was relatively quiet in the federal tax courts. The Fifth Circuit's holding in *McCord v. Commissioner* (case abstract included in this issue) captured BV headlines, primarily for its reversal of the Tax Court's determination of marketability discounts. But the decision turned on the continued viability of the defined value gift clause; so it leaves open the question of the appropriate methodology and data for determining discounts, which is bound to be a big issue in 2007. And though estate planners may be tempted to use the defined value gift clause, it may still flag the attention of IRS examiners as much as any high-dollar transaction or significant discount.

In another high-impact Tax Court case last year, *Dallas v. Commissioner* highlighted the continued uncertainty of valuing subchapter S Corporation earnings. In declining to tax-affect in an estate/gift tax scenario, the *Dallas* court distinguished the recent decision by the Delaware Chancery Court in *Delaware Open MRI Radiology v. Kessler*, which applied tax-affecting in an appraisal action. Rather than ending the debate, the distinction widened it, according to many BV analysts, so watch for tax-affecting to remain a key issue this year.

IRS gets tough on appraisers, too

The passage of the Pension Protection Act of 2006 (PPA)—including its attendant penalties for appraisers and appraisals—will continue to impact the profession. Many see the new legislation as part of a bigger trend toward the

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5th Circuit Reverses McCord, Confirming Original Marketability Discounts

McCord v. Commissioner of Internal Revenue, 2006 U.S. App. LEXIS 21473 (August 22, 2006)

In one of the biggest upsets in business valuation law, the Fifth Circuit Court of Appeals recently overturned *McCord v. Commissioner*, 2003 U.S. Tax Ct. LEXIS 16 (2003) (*McCord I*). Most analysts and attorneys know the 117-page *McCord I* for its determination of marketability discounts, where the Tax Court rejected the taxpayer's restricted stock analysis and endorsed the criticism of pre-IPO studies.

McCord I revisited

In January 1996, the McCord family transferred all of their interests in a limited partnership (ML) to exempt and non-exempt donees by an Assignment Agreement. Rather than use percentage interests, however, they conveyed dollar amounts of the net fair market value of the partnership interests pursuant to a sequentially structured dollar formula or "defined value clause." In conjunction with the Assignment Agreement, the taxpayer's appraisal calculated that each donee would receive approximately \$89,000 for each 1% of limited partnership interest at the time of the gifts. Approximately two months later, the donees signed a separate Confirmation Agreement, which translated the dollar value of each gift under the Assignment Agreement's defined value formula into percentages of interests in the partnership.



A procedural anomaly

The taxpayers used the appraisal to calculate their gift tax returns, including a 35% discount for lack of marketability based on their expert's analysis of restricted stock studies, as well as supporting data from pre-IPO studies. But the IRS assessed over \$4 million in deficiencies. The Commissioner's valuation conclusion was nearly twice that of the taxpayers—and was based on its rejection of pre-IPO studies, including its expert's opinion that a 7% marketability discount was appropriate.

The parties originally tried the dispute before Judge Maurice B. Foley of the Tax Court, based primarily on stipulations and the Service's argument that the "defined value gift clause" violated public policy. But Judge Foley held that the IRS had failed to meet its burden of proof on any contested issue and could not prevail.

Two years later, however, the Tax Court's Acting Chief Judge retroactively took the case away from Judge Foley and reassigned it to what resembled an *en banc* panel. This uncommon proceeding ultimately produced *McCord I* from an eight-judge majority, with concurring and dissenting opinions from five other justices. The majority crafted its own interpretation of the Assignment and Confirmation agreements.

[T]he majority in essence suspended the valuation date of the property that the Taxpayers donated in January [per the Assignment Agreement] until the date in March on which [per the Confirmation Agreement] the disparate donees acted, post hoc, to agree among themselves on the...partnership percentages that each would accept as equivalents of the dollar values irrevocably and unconditionally given by the Taxpayers months earlier.

The result was, as Judge Foley pointed out in his dissent, a "tortured" analysis of the Assignment Agreement that required the taxpayers to use the majority's valuation to determine the dollar value of the transferred interest, but its own appraisal to determine the percentage interests transferred. "There is no factual, legal, or logical basis for this conclusion."

The 5th Circuit agreed: This "unique methodology violated the immutable maxim that post-gift occurrences do not affect and may not be considered in, the appraisal and valuation processes..." The 5th Circuit's opinion also stated "...the methodology employed by the Majority in determining the taxable and non-taxable values of the various donations constitutes legal error, the results of the Majority's independent appraisal the donated interests in MIL and their values for gift tax purposes become irrelevant to the amount of gift taxes owed by the Taxpayers."

As the Tax Court had correctly rejected the Commissioner's valuation—but incorrectly applied its own "imaginative" methodology—the values left were those which the taxpayers had filed with their original return. Affirming without discussing the calculation of marketability discounts, the 5th Circuit allotted the remainder of its analysis to the Tax Court's final legal error—its failure to apply a discount for the present negative value of the donees' assumption of estate tax liability under IRC Section 2035.

Harsh words for the Service

In its note that the IRS deficiency notices were almost twice what the taxpayer filed, the Court observed, "this exemplified a practice of the IRS that we see with disturbingly increased frequency, e.g., a grossly exaggerated amount asserted in a notice of deficiency."

It's anyone's guess whether the IRS will heed such reprimand from the "taxpayer friendly" 5th Circuit. But this reversal means that *McCord I* has lost most of its precedential value; and though the appellate decision is binding only on the 5th Circuit, analysts and attorneys are likely to cite it as support for traditional valuation approaches. □

Kohler: Textbook Valuation of Large Closely Held Corporation Leads to Total Victory for Taxpayer

***Kohler v. Commissioner of Internal Revenue*, 2006 Tax Ct. Memo LEXIS 156 (July 25, 2006)**

Everything went right for the taxpayer in the *Kohler* case. A leading manufacturer of kitchen and bath products, Kohler had been a privately held family business for nearly two hundred years, paying annual dividends since 1900. The Company's stated policy is to pay 7% to 10% of its earnings in dividends and reinvest the remainder. Kohler also issued two business plans: A management plan, which was a realistic projection of achievable targets; and an operations plan, which was a theoretical, "best case" projection. Kohler regularly updated its management plan for lenders and insurance companies; its operations plan was for internal use only.

Reorganization in 1998

To recapture the 4% of stock held outside the family, Kohler effected a tax-free reorganization (under §368(a) of the Internal Revenue Code). During the reorganization, on March 4, 1998, Frederic Kohler died. Kohler's estate retained the appraiser who had performed periodic valuations for the company and he appraised the estate's holdings at a fair market value of \$47.01 million as of September 4, 1998 (six months after decedent's death, the alternate date permissible under §2032 IRC). After an extended audit, the IRS determined the fair market value of the Kohler holdings on the alternate date to be \$144.5 million.

A critical shift in taxpayer's favor

In most cases, the taxpayer must prove that IRS deficiency notices are incorrect; the burden shifts if the taxpayer can show well-maintained records and cooperation with the IRS. In this case, the Kohler estate had mounted an unsuccessful motion to quash, based on legitimate concerns for corporate confidentiality, but then it had complied with all IRS requests. The company's initial resistance did not obviate its subsequent and complete cooperation, which helped shift the burden to the IRS to prove that the taxpayer was liable.

The IRS also lost a bid to value the Kohler estate on the date of Frederic's death, because it missed a procedural deadline for amending its pleadings. The question still remained whether, on the alternate valuation date, the Kohler stock should be valued before or after the reorganization. The IRS tried to "back-door" its argument by claiming the Court should either: (a) value the pre-organization stock on the alternate valuation date; or (b) ignore the transfer restrictions and purchase option in valuing the post-organization stock.

The taxpayer won on this point, also. Pursuant to §2032(a), the executor of an estate is allowed to value the estate's property at an alternate valuation date, six months after the date of death. Property which has not been distributed or otherwise disposed of within 6 months after date of death is valued at the alternate date. The Kohler stock is treated as not having been disposed of as of the date of reorganization, May 11, 1998, since under §368(a) stock exchanged for stock in a tax-free organization, such as this transaction, is not treated of as being disposed of under §2032(a). Therefore the Kohler stock is appropriately valued on the alternate date of September 4, 1998.

Credentials, USPAP certification, and valuation methodology are keys to valuation credibility

The narrow question then became the fair market value of the post-reorganization Kohler stock on the alternate valuation



ation date. Given its decision on burden of proof, the Court first considered the IRS expert report, which lacked USPAP certification (Uniform Standards of Professional Appraisal Practice) regarding the appraiser's compliance with standards and independence. The Court also noted that the expert lacked valuation-specific credentials, although he was a Ph.D. and a CFA (Chartered Financial Analyst).

In his income approach, the expert had declined to use a dividend-based method, preferring a discounted cash flow (DCF) method instead. However, he opted not to use Kohler-provided projections, making his own expense assumptions "without first discussing them [with] anyone at Kohler," according to the Court. He created two DCF models, one using revenues from the company's management plan and the other from its operations plan, giving the former a 20% weight versus 80% for the latter, because he believed the "aspirational" plan was the more likely scenario. The Court disagreed, saying he weighted the results "inconsistent with reality of the business."

The IRS expert had also made a last-minute correction to his income approach values, which had overvalued the Kohler stock by \$11 million—"not a minor mistake" according to the Court. He had also applied a market approach, using the guideline company method (80% weight) as well as the transaction method (20%), averaging the two and applying a 25% discount for lack of marketability.

In its final analysis, the Court found that: (1) the IRS had declined to use a dividend approach for a private company with a long and consistent dividend policy; (2) it had weighted a theoretical operations plan over a realistic management plan; and (3) it had failed to use management projections. The IRS had thus failed in its burden of proof. "Accordingly, we find the value of the estate's stock to be [as] reported on its return, \$47,009,625."

Court's Opinion of Experts

In its review of the valuation experts, the Court noted that it gave no weight to the IRS' expert. He did not introduce any evidence to persuade the Court that the value reported on the estate's tax return was incorrect and that the respondent failed to meet the burden of proof. In contrast, the Court completed its record with high praise for the taxpayer's valuation reports, the one it had filed with its original return and a second report obtained for trial. Both appraisers were well-credentialed, with extensive professional, teaching and publishing experience. Their reports provided "thoughtful, credible valuations" that strongly supporting the estate. Highlights include:

- One appraiser was "very familiar" with company management and operations, having performed periodic

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Bullet-proofing a Buy-Sell: Problem Areas to Address Before Signing the Agreement



Many parties negotiate a buy-sell agreement under the assumption that the “other guy will go first.” Whether naïve or optimistic, the premise can prove true for only one of them and a triggering event such as death, divorce, shareholder dissent, or other departure can expose parties to a buy-sell agreement to a multiplicity of problems.

A better tactic would be to identify the concerns of the parties at the outset while their interests are still aligned. Even better would be to engage a valuation appraiser during the negotiation of the buy-sell to propose “up-front” solutions to the problems that are likely to arise and to ensure that the agreement addresses both the amount and liquidity of the transferred shares. Although some clients may balk at the additional professional fees, these are minimal compared with the expensive—and extensive—litigation that can ensue from a poorly drafted or incomplete buy-sell agreement.

Most common pitfalls

Often, it's less important how clients resolve certain valuation issues, as long as their buy-sell agreements are clear and unambiguous and reflect the parties' intent. A business appraiser can help resolve the “how,” while the following checklist will help the parties as well as their attorneys and accountants identify the most troubling issues associated with buy-sell agreements:

- **Standard of value.** A buy-sell agreement must clearly specify the standard of value. Some agreements simply mention “the value” of the company or interest: Does this mean fair market value, fair value, or some other standard? Each of these terms denotes a significantly different interpretation. If the agreement is not clear, the parties will have to try to agree on a standard of value upon a triggering event, long after their interests have diverged.
- **Book value.** One of the biggest problems is using the book value standard, as this often does not compensate the withdrawing or deceased shareholder for the value of intangible assets, for example, or contingent liabilities not reflected on the balance sheet. An inference that the book value of the shares equals their fair market value may depend on unwarranted or unreasonable assumptions, which may not account for changed conditions from the negotiation of the buy-sell to its triggering event.
- **Goodwill.** The agreement should also specifically address whether goodwill stays with the remaining shareholders.
- **Level of value.** Values can range from a controlling interest in a company to a nonvoting or nonmarketable minority interest to an illiquid, minority interest. Different assumptions apply to each level, such as the application of discounts or control premiums. If possible, buy-sell provisions should clearly identify which, if any, discounts and/or premiums apply.
- **Valuation date.** The “as of” date clearly identifies when the appraiser should value the interest and grounds the appraisal in such relevant and time-sensitive factors as the company's financial performance, the local and national economic conditions, etc.. The “as of” date could be the triggering event, the last fiscal year, an annual ESOP appraisal, or some other date or event.
- **Appraisal/arbitration process.** This is a key provision, defining the rights of each party to obtain an appraisal and involving a single arbitrator/appraiser or a panel of two or three appraisers. The agreement must decide when the arbitrator(s) will be chosen—at the start of the engagement (preferable) or after a dispute has arisen; and who will choose the appraiser(s). A “shotgun” approach permits one party to provide the value, the other party to choose the share. Rights of first refusal can also provide a sanity check.
- **Appraiser qualifications.** Some buy-sell agreements identify a specific appraiser or list of appraisal firms; others address the credentials and specific qualifications of the appraiser, such as practice scope, industry expertise, education and training. Without these, a real estate appraiser or general accountant could qualify. Provisions can also identify specific appraisal standards of various professional societies or the IRS.
- **Payment provisions.** How will the agreed-upon value be provided to the departing or deceased shareholder? Can the company afford the price? What funding mechanism will be used?
- **Miscellaneous.** Additional provisions can address time limits for each step of the appraisal, provisions to break deadlocks, alternative dispute mechanisms and third party involvement. Some buy-sell agreements even provide for psychological or “family” counseling to reduce conflict and ease the transition. □

creation, issuance and/or revisions of standards applicable to the providers and users of BV services. In addition to the PPA, last year also saw:

1. Substantial changes to the BV provisions of the Uniform Standards of Professional Appraisal Practice (USPAP)
2. Another exposure draft on BV Standards from the American Institute of Certified Public Accountants (AICPA)
3. Updated BV guidelines from the IRS
4. FASB's release of SFAS 157 on fair value measurements (along with updates on SFAS 123R, 141 and 142) and its continued work with the International Accounting Standards Board (IASB) toward a convergence of fair value standards
5. A new task force formed by the International Valuation Standards Committee (IVSC), charged with drafting global valuation standards and fair value guidance
6. A similar BV task force formed by the Appraisal Foundation

BV Undergoing Extraordinary Changes

The rapid development and dissemination of new standards and new information has brought extraordinary change to the business valuation profession. While BV used to be a niche practice area, it's now considered by many to be a general practice area with various specialized niches, including fair value measurements but also valuations in health care, ESOPs, intangible assets, M&A, lost profits/economic damages and the like.

To practice competently in any one of these niches requires significant commitment to the work and to greater accountability and credibility within the BV profession. In rising to the challenge to "raise the bar," BV practitioners will be seeking more opportunities to better serve their community of clients in the financial, auditing and legal professions. □

valuations before; the second appraiser spent three and a half days at the company interviewing 12 employees, including considerable time with the president and the general counsel/executor of the estate.

- In their income approaches, both experts used a discounted dividend method, "important indicators of value where dividends represent the best, if not the only opportunity for minority shareholders to receive a cash return on...investment," the Court said.
- In their market approaches, both experts used the guideline company method, because there were insufficient comparables for the transaction method. One expert identified publicly traded companies in each market segment in which Kohler operated and applied multiples, weighting each valuation conclusion based on the relative portion of Kohler's business that each comprised.
- Both experts also applied a discount for lack of marketability under the DCF and capital market methods (45% and 35%, respectively) and a discount for lack of control (25% and 26%, respectively). □

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