

Viewpoint on Value

Black and Blue, Inc.

Impaired businesses need a thorough assessment of economic damages

The future is Now

Many business owners inadequately address succession planning

Tax Court Decision Affects Valuation Adjustments

The Great
S Corporation Debate
Should Their Earnings
Be Tax-Affected?



PLUS: Shareholder Disputes: Involve a Valuator Early

MillerMusmar
CPAs • ADVISORS • INNOVATORS

FSG

1861 Wiehle Ave, Suite 125
Reston, VA 20190
Phone 703.437.8877
Fax 703.437.8937

10502 Crestwood Drive
Manassas, VA 20109
Phone 703.365.8877
Fax 703.365.8937

875 SE 47th Terrace, Suite 4
Cape Coral, FL 33904
Phone 239.542.8811
Fax 239.542.8937

Black and Blue, Inc.

Impaired Businesses Need a Thorough Assessment of Economic Damages

From breach of contract and patent infringement to outright negligence, commercial torts often give rise to economic damages. In these cases, it's critical to put a precise dollar amount on how much business the company stands to lose. And many factors go into this assessment.

A Formal (But Concise) Thesis

Most valuers start with a generic “theory of damages” statement. For instance, a basic preliminary statement might be:

But for ABC Manufacturing Co.’s breach of the parties’ exclusive supply contract, XYZ Supply Co. would have sold more widgets.

As the valuator reviews financial information and conducts additional research, he or she refines the theory of damages and fills in the holes.

The conclusion should address specific assumptions and parameters, such as decreased sales volume, incremental profits per unit and duration of the damage period. To illustrate, the previous example might evolve into:

But for ABC’s purchase of 1 million widgets from alternate suppliers, which violated the parties’ exclusive supply contract, XYZ would have sold another 1 million widgets to ABC at an incremental profit of \$0.50 each over the 12 months remaining until the contract’s expiration.



A fine-tuned thesis helps the litigants, judge and jury quickly evaluate the validity of the valuator’s final conclusion.

3 Popular Methods For Calculating Damages

Arriving at a succinct theory of damages takes time and diligence. Valuers generally use the following three approaches to estimate lost profits or diminished business value:

1. The before-and-after method. This approach assumes that, if it hadn’t been for the tortious act, the company’s operating trends would have continued in pace with past performance. In other words, damages equal the difference between expected and actual performance. A similar approach quantifies damages as the difference between the company’s value before and after the alleged tort occurred.



2. The yardstick method. Under this approach, an appraiser benchmarks a damaged company’s performance to external sources, such as publicly traded comparables or industry guidelines. The presumption is that the company’s performance would have mimicked that of its competitors if not for the tortious act.

3. The sales projection method. Here a valuator relies on subjective estimates of a company’s probable cash flow. Damages involving niche players and startups often call for the sales projection method, because they have limited operating history and few meaningful comparables.

An appraiser considers the specific circumstances of the case to determine the appropriate valuation method (or methods) for that particular situation.

The Next Step

After they’ve projected lost profits, valuers discount their projections to present value. Some jurisdictions

have prescribed discount rates, but, in many instances, appraisers subjectively build up the discount rate based on their professional opinions about risk.

Small differences in the discount rate can generate large differences in valuator's final conclusions. As a result, the subjective discount rate is often a contentious issue.

Finally, valuers address mitigating factors. What could the damaged party have done to minimize its loss? Most jurisdictions hold plaintiffs at least partially responsible for mitigating their own damages. Similar to discount rates, this subjective adjustment often triggers widely divergent opinions among the parties involved.

A Tricky Matter

Calculating economic damages is necessary in many different sets of circumstances — but, because of the large number of subjective factors, doing so can be tricky. Valuers use several different methods and consider both financial and nonfinancial factors to ensure their calculations are as sound as possible. □

CALCULATING THE WHOLE TRUTH (AND NOTHING BUT)

The ultimate goal of any economic damages resolution is to make the plaintiff “whole” again. Some key factors need to be considered to ensure this happens and avoid over- or under-estimating a damaged business's loss. Here are three important considerations:

1. Taxation of damages. Most damage awards are taxable. If the plaintiff must pay taxes, an after-tax assessment will be inequitable. Also realize that some parts of a damage award, such as return of capital, may be nontaxable and require an after-tax estimate.

2. Application of a pretax discount rate. Calculating pretax damages requires the use of pretax discount rates. Mismatching after-tax discount rates to pretax cash flows would overstate damages, all else being equal.

3. Assumption that damages will occur over a finite period. Economic damages generally occur over a finite period. That is, they have a beginning and an end. Eventually plaintiffs can overcome the effects of tortious actions. Some financial experts, however, incorrectly assume that damages will continue into perpetuity.

If time and budgets permit, allow your expert an opportunity to review the opposing expert's analyses. He or she may find that the opposition didn't take into account one or more of these key factors.

The Future is Now

Many Business Owners Inadequately Address Succession Planning

For business owners everywhere, and particularly baby boomers approaching retirement, succession planning is an important issue. A formal plan is critical to ensuring that ownership of the company passes smoothly when the owner leaves and, ultimately, to preserving the stability of the business.

But retirement isn't the only reason to create a succession plan. Disability, death and even unforeseen marketplace changes can drive owners to sell or

depart from a company. Despite this importance, surprisingly few business owners have taken the time to adequately address their succession planning needs.

A Crowd Gathers

Many business owners assume that the market will be ripe with willing buyers when they're ready to retire. Unfortunately, a buyers' market is expected to ensue as baby boomers retire en masse. The oversupply of

sellers will likely depress pricing multiples and allow buyers to be pickier when selecting acquisition candidates.

Bottom line: A sale may not be the most viable exit strategy. Instead, owners may need to groom a second generation of leaders from the inside.

All in the Family

Family-owned businesses face their own succession planning challenges. Less than a third of family-owned businesses are successfully transitioned to second-generation management.

In some cases, entrepreneurs automatically assume that their children have the ability and desire to carry on the torch. Other parents just can't let go, and their ongoing involvement undercuts the successor's ability to manage the business.

Family business owners should realistically assess their heirs' skill sets as well as their personal and professional goals. Although some parents find it difficult to admit, they may be wiser to sell the business over to unrelated employees or another third party.

**Savvy Succession
Agreements Can
Provide Retirees With
Ongoing Cash Flows
And Minimize Taxes.**

Furthermore, when first-generation owners decide to retire, they should formally relinquish control and avoid providing unsolicited advice to the new management team.

Valuators To The Rescue

Fortunately for any company — family-owned or otherwise — help is available. Valuators can work with business owners to develop comprehensive succession plans. The following list provides a sampling of the ways appraisers can help business owners with their succession plans:

Establish reasonable valuation expectations. Often, business owners have only a vague notion of what

their business interests are worth. Valuators can provide industry rules of thumb and rough preliminary value estimates to avoid unpleasant surprises upon retirement.



Devise creative buyout terms. Savvy agreements with the next generation of leaders can provide retirees with ongoing cash flows and minimize taxes. Possible alternatives include installment sales, earnouts and consulting agreements. Appraisers may also advise business owners about funded retirement plans, such as profit-sharing plans, 401(k)s and Roth IRAs.

Propose detailed practice continuation agreements. Sole proprietors, single-owner firms and other parties to these unique contractual arrangements are typically competitors who mutually agree to buy each other's businesses if the current owner dies, retires or becomes disabled.

Discuss gift and estate planning issues. When second-generation owners are related parties, gift and estate planning becomes even more significant. Valuators can also draft formal valuation reports to accompany gift and estate tax returns.

Provide input on valuation-related provisions of buy-sell agreements. For example, an appraiser may prescribe predetermined pricing multiples, methodologies or valuation discounts to help ensure the agreement's validity and usefulness.

Today's The Day

Business owners need help protecting their most valuable personal assets — their private business interests. Succession planning shouldn't be put off until the last minute. It requires forethought and diligence. For owners who haven't started planning yet, there's no time like the present. □

Tax Court Decision Affects Valuation Adjustments

When it comes to valuing private business interests for gift and estate purposes, taxpayers and the IRS rarely see eye to eye. The *Estate of Jelke v. Commissioner* is no exception. In this landmark case, the Tax Court confronted three contentious valuation adjustments: built-in capital gains tax, minority interest discounts and marketability discounts.

Case Background

When Frazier Jelke III died in March 1999, he owned 6.44% (or 3,000 shares) of Commercial Chemical Co. (CCC). Subsequent to the sale of its chemical manufacturing operations in 1974, CCC operated as an asset-holding C corporation that maintained a diversified portfolio consisting primarily of large-cap public stocks, such as Exxon, General Electric, Hewlett-Packard, Microsoft and PepsiCo.

CCC was professionally managed and offered shareholders a relatively high rate of return. In fact, CCC's average annual return was approximately 23% from 1994 to 1999. In addition, its management had no short-term liquidation plans.

Both sides agreed that the undiscounted net asset value of CCC was approximately \$188 million, excluding its \$51 million built-in capital gains tax liability. But they differed substantially in their estimates of the value of the decedent's interest in CCC.

The estate asserted that the value was roughly \$4.6 million, including a reduction for the full capital gains tax liability, a 20% minority interest discount and a 35% marketability discount. Using more conservative valuation adjustments, the IRS calculated the value at about \$9.1 million.

Issues At Stake

The case brought to light some common and important issues concerning privately held businesses. These include:

Built-in capital gains tax liability. If CCC had sold off its assets in March 1999, the company would have incurred a \$51 million capital gains tax bill. In light of CCC's relatively low turnover and intentions to continue as a going concern, the IRS argued that the prospective tax liability should be discounted to reflect the time value of money.

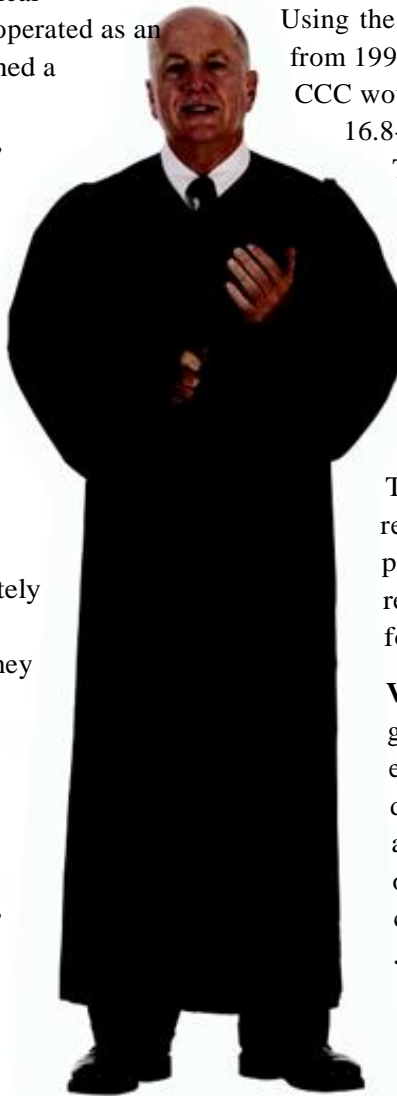
Using the company's 5.95% average turnover rate from 1994 to 1998, the IRS expert assumed that CCC would incur its capital gains tax over a 16.8-year period (100% divided by 5.95%).

The expert discounted this cash flow stream using a 13.2% discount rate based on the average annual rate of return for large-cap stocks from 1926 to 1998. Under these assumptions, the net present value of the tax liability was approximately \$21 million.

The Tax Court sided with the IRS and reduced the value of the holding company by the discounted amount, which resulted in an 11.2% effective discount for built-in capital gains tax.

Valuation discounts. After analyzing a group of closed-end mutual funds, the estate applied a 25% minority interest discount. In contrast, the IRS arrived at a 5% minority interest discount based on an average 8.61% discount for closed-end funds obtained from a *Journal of Economics* article.

After comparing discounts from the estate's sample of closed-end funds and comparing their performance



to CCC's, the Tax Court chose a 10% minority interest discount.

Marketability discounts. The estate and the IRS estimated 35% and 10% marketability discounts, respectively. The Tax Court criticized the estate's use of restricted stock studies without sufficient relevance to CCC. It preferred the IRS expert's *Mandelbaum* analysis, which evaluated CCC's specific operating characteristics (such as financial performance, dividend policies, industry position, management quality, control, transferability restrictions, stock redemption policies and costs of going public).

After performing its own *Mandelbaum* analysis, the court settled on a 15% marketability discount and arrived at a value of the decedent's interest in CCC of approximately \$8.3 million.

Information That Counts

To prevent and defend against IRS deficiency notices, business owners and attorneys should review *Jelke*. In particular, this case presents a unique way of handling built-in capital gains tax issues. It also demonstrates the importance of linking empirical study findings with subject company characteristics when quantifying valuation discounts. □

SHAREHOLDER DISPUTES : INVOLVE A VALUATOR EARLY

Disputing shareholders frequently hold off calling in an expert as they try to rein in mounting professional fees and optimistically hope to settle their differences amicably. But this can lead to unnecessary haste and expense. The proactive use of valuers promotes efficient strategy and, ultimately, saves time and money. Valuers can help in the early stages of a shareholder dispute in several ways. They can:

Evaluate whether the benefits of litigation outweigh the costs. An appraiser can provide a preliminary value estimate. This rough-and-dirty figure can help determine whether pursuing the case is financially feasible. It can also be an objective eye-opener to frustrated shareholders who have unrealistic value perceptions.

Improve the efficacy of discovery. Without a valuator's input during the discovery phase of a case, an attorney who represents a minority shareholder may obtain insufficient financial documentation or forget to request formal site visits. By involving an appraiser from the get-go, attorneys can avoid subsequent trips to court to request additional items.

Increase the likelihood of settlement. By comparing preliminary value estimates, disputing shareholders reveal their expectations and quantify differences. From there, valuers can pinpoint the precise sources of parties' differences and focus litigants on specific financial grievances. Moreover, objective outside experts can help emotionally charged shareholders stay focused on financial issues.

Settlement isn't always possible. If trial becomes unavoidable, valuation expertise provides a head start. In fact, much of the legwork will have already been completed by the time a trial date is set. And waiting until the last minute to hire an appraiser gives the judge and jury a bad impression.

Moreover, time-crunched experts are more likely to overlook key financial items or skip analytical procedures. When valuers are hired at the case's onset, they have adequate time to perform comprehensive analyses of the facts.



The Great S Corporation Debate

Should Their Earnings Be Tax-Affected?

To minimize their corporate tax bills, some business owners elect to operate their companies as S corporations. In a nutshell, S corporations don't pay corporate-level tax. Instead, the tax liability flows through to shareholders personally, similar to owners of partnership units.

Unlike C corporation dividends, S corporation distributions aren't subject to personal taxes. After a statutory holding period, a prior C corporation's subsequent Subchapter S election also allows the company to avoid corporate-level capital gains tax.

In recent years, valuers, the IRS and corporate attorneys have debated whether the tax advantages of S corporation status translates into higher values, all else being equal. Although no clear consensus has arisen, the most agreed-on answer seems to be "sometimes."

A Turning Point

Before the late 1990s, most appraisers believed that the values of otherwise identical S and C corporations were equivalent. Even though S corporations technically pay no corporate-level income tax, appraisers customarily tax-affected earnings — that is, they subtracted corporate-level taxes as if the S corporation were a C corporation before applying the income or market approaches to value.

All that changed in 1999, when the Tax Court began ruling that, because of their tax advantages, S corporations were worth *more* than otherwise identical C corporations. In fact, in certain cases, the court began to mandate the application of after-tax discount rates to pretax S corporation earnings.

Matching pretax earnings with after-tax discount rates generates higher values for S corporations, which are based solely on the owners' choice of entity type.

The Crux of the Debate

It's at this point, of course, that the debate broke out. Proponents of tax-affecting S corporation earnings



argue that a superficial Subchapter S election provides no economic advantage and entity choice has no impact on a company's operating cash flows. Further, they state that an S election doesn't make a company a more attractive acquisition candidate, all else being equal.

Others contend that the correct treatment depends on whether the valuator is appraising a controlling interest or a minority interest. The general consensus is that controlling interests in otherwise identical S and C corporations are worth virtually the same amount.

But when valuing minority interests in S corporations, valuers can no longer automatically tax-affect S corporation earnings. Instead, the decision requires careful consideration of relevant facts, including historic and expected distributions as well as shareholder rights and restrictions.

Ultimately, appraisers must decide on a case-by-case basis whether a minority interest is worth the same, more or less than a similar interest in a C corporation.

An Uncertain Future

In light of this controversy, many have become understandably gun-shy about tax-affecting S corporation earnings. Nevertheless, doing so may be appropriate in some situations. Further court decisions will more than likely be necessary to finally resolve this issue. □