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Business Valuation, Forensic Analysis, and Financial Opinion Insights

Focus on Gift Tax, Estate Tax, and Generation-Skipping Transfer Tax Valuation Insights

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Thought Leadership

Insights

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Focus on Gift Tax, Estate Tax, and Generation-Skipping Transfer Tax Valuation Insights
Editor for This Issue: Fady F. Bebawy

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2015 Recipient of the Apex Literary Award

Forethoughts

This *Insights* issue focuses on current developments with respect to gift tax, estate tax, and generation-skipping tax valuation issues. These issues involve the valuation of closely held companies, of closely held securities and other ownership interests, and of family-owned intangible assets and intellectual property.

This *Insights* issue presents discussions related to (1) the application of the income approach to value closely held ownership interests and (2) the measurement of the appropriate discount for lack of marketability (DLOM) related to the illiquid valuation subject. This series of discussions considers the DLOM for both (1) controlling ownership interests and (2) noncontrolling ownership interests.

This *Insights* issue presents a review and critique of the Internal Revenue Service (the "Service") "Job Aid" related to the valuation of noncontrolling ownership interests in S corporations. And, this issue presents a commentary on the regulations that the Service recently proposed with respect to the elimination of the DLOM in the estate tax valuation of a family limited partnership.

Additional discussions included in this *Insights* issue relate to (1) the valuation of contract-related intangible assets and (2) the disaggregation of the total amount of goodwill associated with a closely held business. Such total goodwill is often disaggregated between (1) the institutional goodwill owned by the entity and (2) the personal goodwill owned by the entity shareholders. This issue also presents a discussion on the structuring of prior shareholder (now employee) payments during the transition after the acquisition of a closely held business.

This *Insights* issue also presents a discussion of the generally accepted approaches and methods related to the valuation of closely held company goodwill—for gift tax, estate tax, and income tax purposes. And, this issue presents a discussion of the factors that corporate buyers and sellers should consider when making a Section 338 tax election.

Finally, this issue includes a symposium that presents the experience and expertise of several prominent legal counsel who practice in the trusts and estates discipline.

About the Editor

Fady F. Bebawy

Fady F. Bebawy is a vice president in the Willamette Management Associates Chicago office.

Fady has over 20 years experience providing a wide variety of business valuation and financial advisory consulting services for purposes of (1) income tax, gift tax, and estate tax; (2) transaction opinions; (3) commercial damages disputes; (4) intercompany transfer price disputes; and (5) shareholder oppression and dissenting shareholder appraisal rights disputes.

Fady holds a master of business administration degree from the University of Chicago Booth School of Business with concentrations in finance, economics, and international business. Fady holds a bachelor of science degree in business administration from New York University with a major in accounting.

Fady holds the certified management accountant (CMA) designation from the Institute of Management Accountants. He a candidate for the accredited senior appraiser (ASA) credential with the American Society of Appraisers. Fady is a member of the Chicago chapter of the American Society of Appraisers and of the Business Valuation Association.

Fady focuses his practice on business valuations for trust planning, gift tax, and estate tax purposes, for transfer pricing purposes, and for commercial damages analysis purposes. Recently, Fady has worked on the following types of cases: (1) a trust case for a multi-billion dollar publicly traded real estate investment company; (2) an estate tax case for a $250 million oil and gas investment company; (3) a gift tax case for a $500 million privately held real estate investment company; (4) a transfer pricing analysis in the *Amazon.com, Inc. & Subsidiaries v. Commissioner* case (Tax Court Docket No. 31197-12); (5) a transfer pricing analysis of a $70 billion publicly traded retail company; and (6) a Delaware Court of Chancery dissenting shareholder appraisal rights case.

In the areas of gift and estate tax, Fady has performed analyses related to the discount for lack of marketability (DLOM). This is an area where both the Tax Court and the Internal Revenue Service have expressed a need for greater support and transparency—as compared to the common analyst procedures of citing the implied discounts from published restricted stock studies and pre-initial public offering (IPO) studies.

Best Practices

Reviewing the Service's Job Aid on the Valuation of Noncontrolling Ownership Interests in S Corporations

Curtis R. Kimball

Valuation analysts often search for ways in which to perform valuation analyses that provide conclusions of value that are reasonable and supportable. However, a supportable conclusion may not be immediately recognized as such. Valuation conclusions will be accepted as valid if the trier of fact is in agreement with the supporting methods, assumptions, and other inputs into the valuation and if this "evidence" points the reader or trier of fact to the same conclusions. Understanding where the Internal Revenue Service auditors are coming from is helpful to all valuation analysts whose work will come under their review. The Service's Job Aid is a framework relied upon by the Service in its review of tax valuations. This discussion provides information that valuation analysts may consider while preparing their valuation analyses.

Introduction

On October 29, 2014, the Internal Revenue Service (the "Service") issued a document called a Job Aid on the subject of valuing noncontrolling interests in corporations electing to be taxed for federal income tax purposes under Subchapter S of the Internal Revenue Code.

These entities are commonly called "S corps" while other taxable corporations are known as "C corps." This discussion reviews the subject S corp Job Aid.

From this review, readers may develop some perspective on two major issues.

First, this discussion will help readers understand the Service's position on how to value noncontrolling S corp interests. This understanding will help the valuation analyst and other taxpayer advisers understand how to format their valuations in a manner that will most likely increase the Service's acceptance of the taxpayer's position when a return is audited.

Second, our review covers the deficiencies of the Service's analysis in its S corp Job Aid and points out missing or poorly documented positions in the Job Aid. This review will help taxpayers and their advisers to rebut unreasonable positions taken by the Service in valuing noncontrolling ownership interests in S corps on audit.

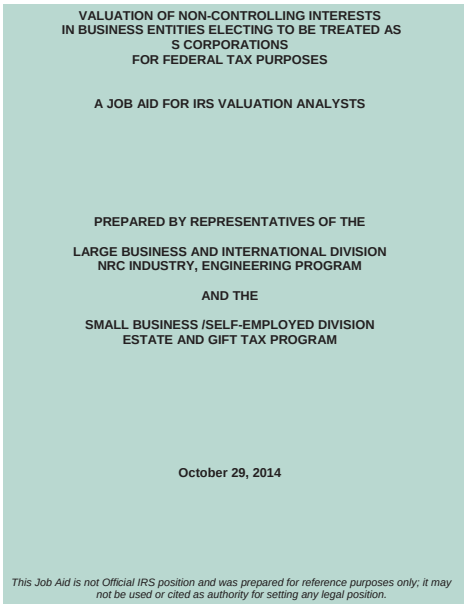
What Is a Service Job Aid?

A Service Job Aid is a reference work developed by Service personnel that discusses and provides guidance on a particular topic. Job Aids are typically authored by a selected task force of personnel with special knowledge or concern regarding the topic under discussion.

Job Aids are meant to be an internal communication conduit within the Service, somewhat like a reference library to aid less experienced examiners encountering an issue for the first time.

The Service has issued Job Aids on a wide variety of topics, ranging from setting forth talking points on new Service initiatives for taxpayers to how to calculate certain penalties.

In addition, the Service also previously issued at least one Job Aid on closely held business


VALUATION OF NON-CONTROLLING INTERESTS
IN BUSINESS ENTITIES ELECTING TO BE TREATED AS
S CORPORATIONS
FOR FEDERAL TAX PURPOSES

A JOB AID FOR IRS VALUATION ANALYSTS

PREPARED BY REPRESENTATIVES OF THE

LARGE BUSINESS AND INTERNATIONAL DIVISION
NRC INDUSTRY, ENGINEERING PROGRAM

AND THE

SMALL BUSINESS /SELF-EMPLOYED DIVISION
ESTATE AND GIFT TAX PROGRAM

October 29, 2014

This Job Aid is not Official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position.

valuations. That Job Aid concerned the discount for lack of marketability and was dated September 25, 2009 (and became public in 2010).

Because Job Aids are internal Service documents, they are often made public via a Freedom of Information Act (FOIA) request. This is what happened in the case of the discount for lack of marketability Job Aid and the subject Job Aid on valuing S corps.

After release under the FOIA, the Service subsequently decided to make Job Aids concerning closely held business valuations (and the related topic of employee shareholder compensation) available on its website.[1]

How official are Job Aids? As noted on the title page of the subject Job Aid: "This Job Aid is not official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position."

Therefore, a Job Aid is not the forum in which the Service publishes its official legal positions.

However, while the *Internal Revenue Manual* does not specifically require examiners to use the Job Aids, these aids are readily accessible for examiners online through the Service intranet.

The U.S. Treasury Department, the department of the U.S. government under which the Service operates, has criticized the Service for not using or documenting the use of Job Aids.

The Treasury Inspector General has indicated that Job Aids should be followed as they provide "a reliable and consistent method for directing and guiding examiners."[2] Thus, Job Aids seem to carry at least a significant amount of informal weight.

A Short History of the Disputes over Valuing S Corp Interests

The valuation of S corp stock and ownership interests in other so-called "pass through entities" (PTEs) has been an area of dispute between the Service, taxpayers, and the valuation profession. Prior to the 2000s, most valuation analysts made no material distinction between valuing S corp shares and valuing C corp shares.[3]

Corporate cash flow was present valued after consideration of the income tax obligations associated with the corporation's income.

This valuation procedure changed with the publication of the *Gross* decision in 1999.[4] The taxpayer lost that case when the Tax Court decided that the subject S corp noncontrolling ownership interest should be valued using pretax cash flow. Subsequent judicial decisions in the Tax Court and other venues were decided in a similar fashion.

These other judicial decisions include the following:

1. *Wall v. Commissioner*[5]
2. *Heck v. commissioner*[6]
3. *Adams v. Commissioner*[7]
4. *Dallas v. Commissioner*[8]
5. *Gallagher v. Commissioner*[9]
6. *Giustina v. Commissioner*[10]

How the S Corp Job Aid Is Structured

The S corp Job Aid consists of 32 pages. The first 20 pages are text, plus there are three appendixes totaling 12 pages. The text consists of three major sections: Executive Summary, Discussion and Analysis, and Assessment and Synthesis.

Appendix A is a reprint of Revenue Ruling 59-60, an outline addressing the issues of valuing closely held business interests in general (with no references to valuing S corp ownership interests).

Appendix B consists of judicial decision citations, as discussed above, in which S corp ownership interests and other PTE interests were the subject of valuation disputes in the Tax Court.

Appendix C incorporates a discussion of one academic study as "evidence-based analysis" even though the study addresses the sale of *controlling* interests in S corps versus in C corps.

A close reading of the subject Job Aid suggests that it is a product of at least two groups within the Service. The Large Business and International Division (LB&I) and the Small Business/Self-Employed Division (SB/SE) are identified as providing representatives to the development of the subject Job Aid.

Within each division, representatives appear to include both attorneys and valuation engineering staff. However, the S corp Job Aid is directly addressed only to LB&I valuation analysts.[11]

Therefore, there may be some compromises embodied in the Job Aid in terms of coverage and detail with regard to explaining the Service's position on valuation. For example, it is noteworthy that the subject Job Aid explicitly avoids the discussion of the valuation of controlling ownership interests in S corps, even though the only academic literature cited concerns controlling ownership interests in S corps.

What Is in the Job Aid?

For a Job Aid that allegedly addresses the valuation of corporate interests, the S corp Job Aid has little substantive detail on methods or calculations that will conclude a fair market value for a noncontrolling ownership interest in an S corp.

The valuation issues in the subject Job Aid that appear important to the Service are stated as broad-based factors that can be summarized as follows:

1. Any income valuation approach should be set up in a manner that does not apply an entity-level income tax to cash flow.[12]

   Therefore, the following methods should be performed using pretax cash flow:

   a. Capitalization of cash flow methods
   b. Discounted future cash flow methods

2. By logical extension, this would also seem to apply to the market valuation approach, as this valuation approach relies on similar cash flow metrics, such as pricing multiples applied to earnings. The Job Aid avoids discussion of this issue, however.
3. No mention is made of the asset-based business valuation approach. Therefore, the reader is not otherwise enlightened as to the Service's opinion on the application of tax-effects to this valuation approach.
4. The Service makes an exception to this policy if the valuation analyst can make "a compelling showing" that arm's-length parties would apply an entity-level tax adjustment to cash flow (or, presumably, some other valuation metric).
5. The Service does state that the application of personal income taxes are "not relevant" in valuing an S corp noncontrolling ownership interest. The stated reason for this position appears to be twofold:

   a. The Service considers the application of a specific personal tax rate to result in a value that is based on an investment value standard of value, rather than a fair market value standard of value.
   b. The source data from Ibbotson (now Duff & Phelps) on rates of return from publicly traded stocks do not consider investor-level taxes.

6. The Service states that the risks attendant to a noncontrolling ownership interest in an S corp should be recognized in the following areas, although the Job Aid provides no analysis as to how these factors should be applied in a quantitative fashion:

   a. As stated in Revenue Ruling 59-60, the determination of value is subject to the specific facts of each case.
   b. Differences in state laws regarding taxation or other applicable factors that are levied on S corps versus C corps should be considered.
   c. Any restrictions or enhancements arising from shareholder agreements or similar corporate or PTE organizational document terms should be considered.
   d. PTEs should be compared to other PTEs, where at all possible.[13]
   e. Adjustments to the costs of capital may be appropriate for S corp valuations, depending on the specific facts of the case.
      i. This can affect the company's ability to raise equity capital.
      ii. This can also affect the company's ability to raise debt capital.
   f. Adjustments to the discount for lack of control may be appropriate for S corp valuations, depending on the specific facts of the case.

      Since the Service indicates that a primary factor is the corporation's distribution paying capacity (and not the current policy regarding distributions), the Service' starting point appears to be a controlling-ownership-interest-based assumption. Thus, for a noncontrolling ownership interest, an explicit adjustment for lack of control is necessary.
   g. Adjustments to the discount for lack of marketability may be appropriate for S corp valuations, depending on the specific facts of the case.

"The S corp Job Aid . . . is helpful in that it points out the areas of valuation analysis that the Service will not accept initially in taxpayer returns that deal with noncontrolling ownership interests in S corps."

h. The previous factors are influenced by the universe of potential willing buyers and sellers that are eligible to hold S corp ownership interests.

7. Any adjustments should be based on "market based" or "data-based" evidence. Academic studies that pass the peer-reviewed standard set forth in *Daubert* are to be given consideration.
   a. The Erickson-Wang study is favorably mentioned, even though it relates to the sale of controlling ownership interests in S corps versus C corps.[14]
   b. The Denis-Sarin study is also mentioned in a footnote.[15]
8. Any theoretical valuation adjustment models that are not based on this type of evidence are not given any weight by the Service. This Service position is based because such models are not "data-based" as noted above.

   This Service position would include a number of models published in peer-reviewed professional journals or adopted in other courts, such as the following:[16]
   a. The Delaware Court of Chancery model[17]
   b. The S corp economic adjustment model (SEAM)
   c. The Treharne model
   d. The Fannon model
   e. The Grabowski model
   f. The Mercer model

What the S Corp Job Aid Leaves Out

The S corp Job Aid leaves out a number of peer-reviewed studies that appeared before the Service issued the subject Job Aid. Therefore, the Service can be accused of cherry-picking the studies it relies on to develop the subject Job Aid. There are at least seven studies of this type.[18]

Furthermore, the subject Job Aid leaves out other articles and publications that have appeared that seem to validate the notion that any premium that may attach to an S corp ownership interest relative to a C corp ownership interest is not as large as the difference seen in capitalizing pretax cash flow versus after-tax cash flow as originally debated in the *Gross* decision.[19]

Summary and Conclusion

The S corp Job Aid published by the Service in late 2014 and made public in March 2015 is helpful in that it points out the areas of valuation analysis that the Service will not accept initially in taxpayer returns that deal with noncontrolling ownership interests in S corps.

The conclusion in the subject Job Aid that only methods utilizing pretax cash flow are acceptable is particularly troubling. This position clashes with the fact that generally accepted valuation models exist that:

1. are based on the after-tax market returns of C corp stock properly matched with after-corporate income tax metrics and
2. make a separate valuation adjustment for any S corp economic advantage.

Nevertheless, valuation analysts may want to modify their models to incorporate pretax cash flow in their analysis in order to avoid the Service's initial objections on audit.

The subject Job Aid is not helpful in that it ignores or minimizes a number of studies and valuation models that are logical and based on market metrics. These flaws and omissions in the Job Aid can serve as a basis for valuation analysts to rebut the Service's position on valuing noncontrolling S corp ownership interests.

The subject Job Aid is also summary in nature and does not provide the reader with any details on quantitative methods that the Service may agree are acceptable.

Notes:

1. These Job Aid documents can be found at www.irs.gov/Businesses/Valuation-of-Assets.
2. www.treasury.gov/tigta/auditreports/2006reports/200630106fr.html.
3. As an example, the reader is invited to review the treatment of S corporation ownership interest valuation issues in each of the editions of *Valuing a Business*, a standard business valuation reference, between 1989 (the second edition) and 2008 (the fifth edition).

Continued on page 16

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Proposed Regulations Related to Section 2704 and the Case for Applying FLP Valuation Discounts

Weston C. Kirk

Over the past 20 years, the Internal Revenue Service has argued that valuation discounts applied in the transfer of family limited partnership and of other family-controlled holding entity ownership interests are "constructed" solely to avoid intergenerational wealth transfer, gift, estate, and generation-skipping transfer taxes. The legal profession and the valuation profession have argued the opposite position: that is, that valuation discounts applied in family wealth transfers are prudent, legitimate, and market-based. This discussion considers (1) proposed regulations with respect to Section 2704 and (2) the case for applying FLP valuation discounts.

Introduction

High net worth families often utilize the family limited partnership (FLP) ownership structure and other entity structures:

1. to move wealth to their heirs during their lifetimes and
2. to safeguard wealth, ensuring that it passes to the right individuals and charities.

An FLP is a type of partnership that typically holds a variety of property (for example, business interests, real estate investments, publicly traded securities, privately held securities) contributed by partners (both general and limited) that are family members.

An FLP is used for one or more business purposes (for example, limited liability, separation of ownership control, compliance with substantial case law, and asset protection from creditors and other adverse parties).

One of the most appealing aspects of an FLP is the ability of a high net worth individual to make transfers of limited partnership interests (via gift, sale, or other transfer) to his or her descendants on a fair market value basis that incorporates a valuation adjustment (i.e., discount).

As compared to the value of the underlying assets of the FLP, valuation discounts are often applicable to transfers of limited partnership ownership interests due to characteristics of:

1. lack of control and
2. lack of marketability.

However, some taxpayers will take advantage of the FLP structure in order to diminish their tax obligation. These bad actors have caused the Internal Revenue Service (the "Service") to scrutinize FLPs.

On May 10, 2015, Cathy Hughes, an attorney-adviser tax lawyer of the Treasury Department's Office of Tax Policy, spoke at an American Bar Association (ABA) tax section meeting. She commented on various proposed regulations, anticipated regulations, and special projects.

One noteworthy comment regarded a proposed regulation with respect to Internal Revenue Code Section 2704(b)(4). This proposed regulation may affect valuation discounts applied to transfers of closely held FLP and limited liability company (LLC) interests.

The Proposed Regulations

Ms. Hughes indicated that the tax and estate planning professions could look to the Obama Administration's prior budget proposals on valuation discounts for clues to what the proposed regulations may provide. In particular, Ms. Hughes indicated that the proposed Section 2704 regulations might be released by mid-September.

However, on September 18, 2015, at an ABA Tax/Real Property, Trust, and Estate Law meeting, Ms. Hughes stated that the Service was "getting closer" but cannot predict when the proposed regulations would be provided. Leslie Finlow, a Service senior technician reviewer, at the AICPA fall tax division meeting on November 4, 2015, noted that guidance of regulations would be submitted "very soon."

Ms. Hughes also said, "We're not looking at the Greenbooks or anything President Obama said four years ago . . . We're looking at the statute, and the statute as it looks now is what you will see at the conclusion."[1]

Some of this delay is probably due to letters sent by some estate planners to the Service. For example, Richard L. Dees, an attorney with McDermott Will & Emery in Chicago, provided a 29-page letter to the Treasury Assistant Secretary of Tax Policy and the Internal Revenue Service Commissioner detailing why implementing the legislative proposals by regulation "would be invalid as contrary to origin, purpose and scope of the current statute."[2]

However, the threat of these regulations to estate planners still exists. The ideal goal from the Service's perspective would be to eliminate intrafamily transfer valuation adjustments, which may represent a 25 to 45 percent discount from the net asset value of the effective underlying assets transferred.

Such proposed regulations seem overreaching and unsupportable when one contemplates the various scenarios under which these regulations would apply. Further, the proposed regulations guidance detracts from the market evidence exhibited for similar investment interests.

The goal of eliminating the apparent abuse of FLP valuation adjustments is easily negated by publicly and privately disclosed transactions of similar interests.

This discussion addresses the background of Section 2704, the to-be-proposed regulations, and the case for applying valuation adjustments for FLPs and other privately held, family-controlled entities.

Background of Section 2704

In 1990, Congress enacted Chapter 14 of the Internal Revenue Code, particularly Sections 2703 and 2704, to prevent the perceived abuses of the tax system. Chapter 14 was enacted to provide a set of rules for estate and gift tax compliance purposes for valuing transfers of equity interests in corporations or partnerships to a member of the transferor's family.

Specifically, Chapter 14 outlines "applicable restrictions" that are appropriate and specifies when such restrictions are disregarded in determining the transferred interest value.

Of the four sections within Chapter 14 (Sections 2701 to 2704), only Section 2702 does not have application to FLPs.

The application of Section 2701, Special Valuation Rules in Case of Transfer of Certain Interests in Corporations or Partnerships; Section 2703, Certain Rights and Restrictions Disregarded; and Section 2704, Treatment of Certain Lapsing Rights and Restrictions, in the context of transfers of equity interests in FLPs, are generally discussed below:

- The sections apply to all transfer restrictions in the partnership agreement.
- The sections are designed to prevent the use of buy-sell provisions, options, calls, puts, or other transfer restrictions to distort the value of the assets for transfer tax purposes.
- The sections provide a safe harbor for transfer restrictions, if restrictions:
  - are a bona fide business arrangement,
  - are not a device to transfer property to family members for less than full and adequate consideration, and
  - are comparable to similar arrangements entered into in an arm's-length transaction.

It is important in the design of the FLP to use state partnership law restrictions on transfer of partnership control (i.e., assignee rights).

Other restrictions on transfer or use of ownership interests should be structured to be consistent with third-party arrangements (i.e., right of first refusal, limitation to hypothecate, etc.).

Section 2704(b), which deals with restrictions affecting the ability of a partnership or corporation to liquidate, is likely to be the focal point of the to-be-proposed regulations.

This section states that if there is a transfer of an interest in a corporation or partnership to a member of the transferor's family, and immediately before the transfer the transferor and his family have control of the entity, any "applicable restrictions" are disregarded when determining the value of the transferred interest [Section 2704(a)].

An "applicable restriction" is defined to be a restriction that limits the ability of the partnership to liquidate, and such restriction either lapses after a transfer or the transferor and members of his/her family, alone or collectively, have the right to remove the restriction [Treasury Regulations Section 25.2704-2(b)].

A restriction is not an "applicable restriction" if it is not more restrictive than the limitations under state law [Treasury Regulations Section 25.2704-2(b)].

Restrictions imposed on the partnership as part of financing or equity participation with an unrelated party are not an applicable restriction for purposes of Section 2704 [Treasury Regulations Section 25.2704-2(b)].[3]

Section 2703(b) provides that Section 2703(a) will not apply to any option, agreement, right, or restriction that:

1. is a bona fide business arrangement,
2. is not a device to transfer the property for less than full and adequate value to family members, and
3. has terms comparable to similar arrangements entered into by persons in arm's-length transactions.

Therefore, if the restriction satisfies the requirements of Section 2703(b), the restriction is considered in the determination of the value of the partnership interest.[4]

Therefore, from a planning perspective, one factor in obtaining valuation discounts in an FLP transfer is to rely on state law restrictions on liquidation and voting rights in the particular state in which you choose to form the FLP.

Section 2704(b) ignores certain "applicable restrictions" on liquidation (which normally would justify a value discounted for lack of control and/or lack of marketability) in valuing family-controlled entity interests that are transferred to other family members.

Relevant Judicial Decisions

Judicial decisions and state statutes have limited the applicability of Section 2704(b) in many cases by recharacterizing restrictions so that they no longer fall within the definition of an "applicable restriction."[5]

In a 2001 Field Service Advice (FSA 200143004), which discusses Sections 2703 and 2704, the Services' Office of Chief Counsel explains how the Service may deploy the provisions in a gift tax matter.[6]

This FSA addressed seven concerns the Service has with regard to family entity transfers. Many of these concerns address case-specific factors. The Service has previously lost in Tax Court on most of the issues it advocates for in the FSA. Nevertheless, the FSA addresses areas that the Service would argue against, such as disregarding the entity as a non-bona-fide business and issues related to gifts on formation of the entity.

An FSA offers guidance furnished by the Office of Chief Counsel upon the request of a Service director or an area director. The FSA is prepared in response to the technical or procedural questions that develop during a proceeding.

A request for an FSA generally stems from an examination of a taxpayer's return, a consideration of a taxpayer's claim for a refund or credit, or any other matter involving a specific taxpayer under the jurisdiction of the territory manager or the area director.[7]

Many of the historical disputes regarding the interpretation of Section 2704 have been argued by use of compliance with Section 2036, which regards an exemption due to a bona fide sale for full consideration. *Bongard*[8] set the base with its "legitimate and significant non-tax reason" test. Subsequent opinions have made a slight modification.

In *Rector*,[9] Judge Laro articulated the test as a "legitimate and significant nontax BUSINESS reason."

In *Rosen*,[10] Judge Laro stated that the "reason was an important one that actually motivated the formation of that partnership from a business point of view."

In *Bigelow*,[11] the judicial conclusion referred to "any legitimate, significant non-tax-related business purpose based on objective criteria."[12]

However, the Service still sees a fair amount of noncompliance with FLP transfers, particularly with respect to proper business documentation with valuations and compliance with Section 2036 and Section 2704.

The Service perceives this as a large loss of revenue resulting from abuses with FLPs, indicating high taxpayer noncompliance.

Potential Restrictions to Be Set Forth in the Proposed Regulations

Treasury regulations are usually effective on the date that the final regulations are issued. Several years typically separate the time regulations are proposed from the time regulations are finalized. In very limited situations, the proposed regulations provide that they will become effective when finalized retroactive to the date of the proposed regulations.

Section 2704 was initially enacted to limit the use of valuation discounts in connection with gifts of family entity interests. The concern was that taxpayers were imposing restrictions on a transferred interest that artificially reduced the value of the gift tax obligation, even though the economic value of the transferred property to the recipients was not similarly affected.

However, Section 2704(b)(4) does state that "[t]he Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

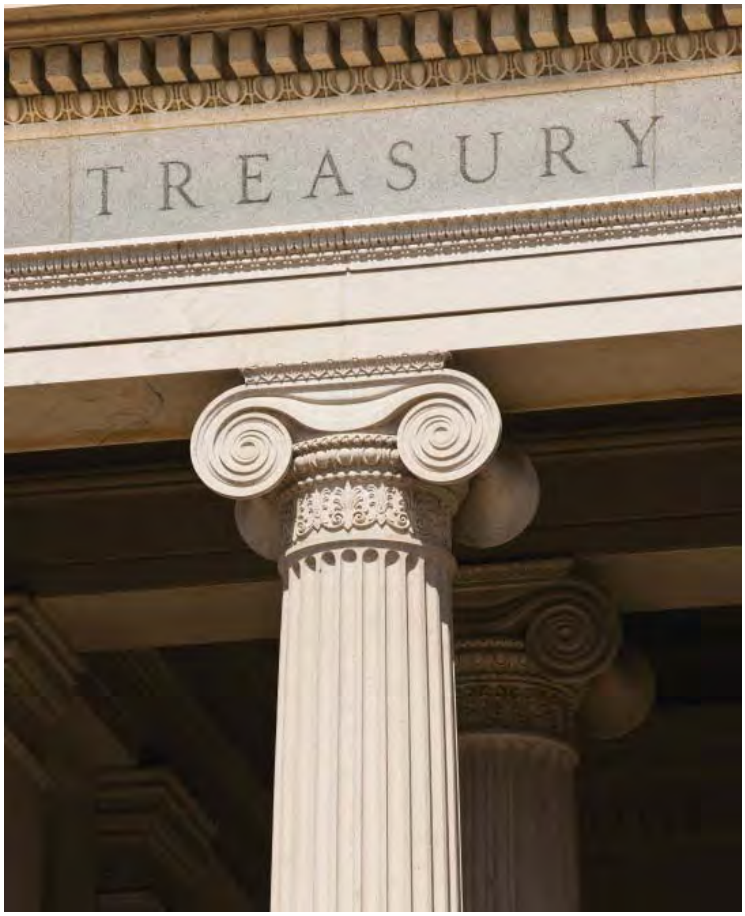
Although most tax professionals believe the Service does not have the authority to ignore control and marketability considerations without legislative approval by Congress, the language provides some broad interpretation for the rumored to-be-proposed regulations to stand ground.

Many practitioners believe that, if enacted, an amendment to Section 2704 would ultimately be overruled by the Tax Court, in a manner consistent with *Kerr v. Commissioner* in 1999.

In that case, the Service argued that the term "applicable restriction" in Section 2704(b) includes any restriction that limits the ability of a partner/member to liquidate its interest in the FLP/LLC that is more restrictive than state law. The Tax Court rejected the Service's interpretation.[13]

Another issue with these Section 2704 to-be-proposed regulations relates to compliance with the precedent Tax Court cases involving gift and estate tax issues. The standard of value used in gift and estate tax analysis is *fair market value*, as this term is used in the regulations under the Internal Revenue Code.

Fair market value is defined as the price at which the subject property would change hands between a hypothetical willing buyer and a willing seller, with



both having reasonable knowledge of all relevant facts, and neither party being under any compulsion to buy or sell.

Fair market value also assumes that the price is paid all in cash or its economic equivalent at closing. The factors surrounding the determination of fair market value are discussed more fully in Revenue Ruling 59-60, as amended and amplified by subsequent revenue rulings and interpreted by the courts.

A deviation from this standard of value would, more likely than not, need to be drafted in any proposed regulation.

These two conflicting areas are likely delaying the Service from issuing any proposals in this area.

On May 10, 2015, Ms. Hughes noted that previous Obama Administration budget proposals could be reviewed for context on how the proposed regulations could be drafted.

The Obama Administration 2010 through 2013 fiscal year (FY) budgets each contained a proposal to restrict or eliminate valuation discounts on transfers of interests in family-controlled entities.[14]

The proposal was dropped from the FY 2014 through FY 2016 budgets. This is most likely due

to a renewed focus to issue regulations under the existing Section 2704(b)(4) rather than attempt to pass new legislation through an increasingly divided congress.[15]

The FY 2013 budget proposed creating an additional category of restrictions ("disregarded restrictions") which would be ignored in valuing ownership interests in family-controlled entities transferred to family members if, after the transfer, the restriction would lapse or may be removed by the transferor and/or the transferor's family (including certain charities and nonfamily members).

The transferred ownership interest would instead be valued by substituting certain assumptions (to be specified by the regulations) for the disregarded restrictions.[16]

The FY 2013 budget proposal provided that such disregarded restrictions would include limitations on a holder's right to liquidate that holder's ownership interest—thus, they would be more restrictive than a standard to be specified by the regulations.

Any limitation on a transferor's ability to be admitted as a full partner or to hold an equity interest in the entity would also be considered a disregarded restriction.[17]

The FY 2013 budget proposed to grant regulatory authority for various purposes, including the creation of safe harbors under which the governing documents of a family-controlled entity could be drafted to avoid the application of Section 2704. The proposal further included conforming changes relating to the interaction of the proposal with the marital and charitable deductions.[18]

The Service is understandably disgruntled by some of the valuation reports that it has to review as support for taxpayer's positions in interfamily transactions. The Service sees some of the worst examples of tax abuse in this area.

Many professional firms have expanded in recent years into the valuation services practice area. This has led to novice valuation reports that are not well supported. In order to rectify this apparent abuse within the valuation profession, the Service seemingly would like to do away with valuation discounts within the trust and estate tax arena.

So until any proposed regulations are issued, many estate planners are quickly structuring FLP transactions prior to the imminent proposed regulations. However, these transactions (either by sale or gift) include many additional clauses that limit, to some extent, the effect of any retroactive regulation effects.

These structuring provisions include the following:

- Dollar value transfers. Dollar value transfers are defined transfers (either by sale or gift) on a certain date; wherein, the percentage interest transferred is determined after a valuation is performed.
- Valuation formula adjustment clause. In case the Service amends the value of the transferred interest, the transaction document will change the percentage of ownership transferred rather than incur an effective gift of ownership.[19]
- Charitable value allocation clause. In case the Service amends the value of the transferred interest, the transaction document will provide that any determined additional gift amount will be transferred to a defined charity (in which case, the Service will not receive additional tax revenue, if any, upon a change in the value of the interest transferred).

The Valuation Analyst's Role

The valuation analyst plays an important role in meeting compliance standards with family-controlled FLP interest transfers between family members. Many of the apparent abuses with respect to Section 2704 are a result of poorly structured and poorly supported valuation reports.

The valuation analyst should:

1. assist in compliance with properly documenting the taxpayer's position,
2. provide experience and expertise in valuing hard to value assets, and
3. provide independence with respect to interfamily transfers.

The valuation of an FLP interest should meet requirements of a "qualified appraisal" prepared by a "qualified appraiser" under Section 170(f)(11)(E)(ii).

According to Section 170, a qualified appraisal is one that:

1. meets the regulations and guidance prescribed by the Secretary of the Treasury (the "Secretary") and
2. is conducted by a qualified appraiser in accordance with generally accepted appraisal standard and any regulations or other guidance prescribed within the section.

The only generally accepted appraisal standard specifically mentioned by the Service is the Uniform Standard of Professional Appraisal Practice, as promulgated by the Appraisal Foundation.

According to Section 170, a qualified appraiser is defined as an individual who:

1. has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary,
2. regularly performs appraisals for which the individual receives compensation, and
3. meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.

Valuation analysts should also meet the Service's "adequate disclosure" requirements for taxpayers to begin the statute of limitations as set forth in Treasury Regulations Section 301.6501(c)-1(f)(3).

For charitable contribution purposes, adequate disclosure for valuations is satisfied if the donor submits a valuation of the transferred property that meets the following requirements:

1. The appraisal is prepared by an appraiser who satisfies all of the following requirements:
   a. The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.
   b. Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued.
   c. The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in Section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either.
2. The appraisal contains all of the following:
   a. The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal
   b. A description of the property
   c. A description of the appraisal process employed
   d. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions
   e. The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value
   f. The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions
   g. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred
   h. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, and so on.

In addition to the compliance-related requirements, a valuation analyst and a valuation firm can provide taxpayers with additional support and defense in case the transfer is audited by the Service. Professional valuation firms should defend their work under contrarian review.

Taxpayers who engage professional advisers can mitigate or eliminate underpayment penalties, fines, and drawn-out, expensive audits.

Issues with the Proposed Regulations

There are numerous unintended consequences of the to-be-proposed Section 2704 regulations. Some of the issues that are not considered in these assumed regulations follow:

1. The market does not support undiscounted values of limited partnership interests.
2. Families do not always get along.

The Market Issue

When valuing a privately held business interest, valuation analysts often start with an examination of public and private market transactions of securities with the same or a similar set of restrictions.

Often, valuation analysts can identify similar securities that assist in creating a proxy of risk

attributable to investment concerns that can be grouped into two areas: lack of control risk factors and lack of marketability risk factors.

These risk factors are often represented as a price discount from the net asset value of the underlying assets of the FLP. These price discounts provide the investor a greater level of assurance that their investment will yield a suitable rate of return upon selling.

These price discounts can be jointly supported through a hypothetical scenario test to understand the likely internal rate of return (IRR) of the investment over the investment horizon. Comparable market investments can assist in understanding what is a suitable IRR for a subject investment interest.

FLP investments are typically not attractive investments or especially unique in any manner. For most FLPs, the underlying assets are investments in cash, bonds, marketable securities, privately held securities, real estate, and debt instruments.

Furthermore, from an arm's-length transaction perspective, the transferee cannot look to sell its interest to all buyers and sellers at a price not discounted substantially from the aggregate fair market value of the FLP underlying assets.

Otherwise, the buyer would simply use his or her own capital to buy similar investments (if not the same investments) as the FLP, retaining control of the investments and having the ability to liquidate on his or her own terms.

Lack of Ownership Control Issues

If the analyst examines publicly traded closed-end funds, the majority (95 percent) trade at discounts from their net asset values. Closed-end funds are similar to FLP limited partnership interests. Investors of each lack control of the underlying assets invested by the entity.

The majority of the discount associated with the closed-end fund trading price is due to lack of ownership control; only a small amount of the discount is often associated with lack of liquidity due to low volume of transactions and market participants, which also yields a large spread between bid and ask prices.

Most publicly traded closed-end funds trade at an 8–20 percent price discount due to characteristics of lack of control.

The following list provides examples of some of the more common prerogatives of ownership control in an FLP entity:

- Elect directors and appoint management
- Determine management compensation and perquisites
- Set policy and change the course of business
- Acquire or liquidate assets
- Select people with whom to do business and award contracts
- Make acquisitions
- Liquidate, dissolve, sell out, or recapitalize the partnership
- Sell or acquire partnership
- Register the partnership's interests for public trading
- Declare and pay distributions
- Change the partnership agreement

Lack of Marketability Issues

In addition to lack of control issues, the lack of marketability of a privately held, family-controlled FLP creates negative characteristics. Most FLP limited partnership interests are discounted between 20 percent and 35 percent for lack of marketability.

This price discount, based on a likely investment time horizon (e.g., 10 years), provides the holder a return (modeled by applying an IRR calculation) commiserate with the risks the investor is taking on in the subject investment.

In *Mandelbaum v. Commissioner*,[20] Judge David Laro cited nine specific (but nonexclusive) factors for analysts to consider in developing a discount for lack of marketability (DLOM):

1. Financial statement analysis
2. Dividend history and policy
3. Nature of the company, its history, its position in the industry, and its economic outlook
4. The company management
5. The amount of control in the transferred shares
6. The restrictions on transferability
7. The holding period for the stock
8. Subject company's redemption policy
9. Costs associated with a public offering

Mandelbaum is cited frequently in decisions related to the measurement of the DLOM. The *Mandelbaum* factors are intuitive, and they reconcile with empirical studies such as the restricted stock studies and the pre-initial public offering studies.

Analyses of the *Mandelbaum* factors, the empirical studies, the theoretical studies, and other DLOM literature make it clear that many company-specific and security-specific factors affect the magnitude of the DLOM.

These types of factors generally fall into three categories:

1. Dividend payments
2. Expected holding period
3. Subject company risk

Market participants must (and do) consider control and marketability risks with an investment in a limited partnership interest of an FLP. These price discounts typically range from 25 to 45 percent of the net value of equity of the FLP. They are supported by market transactions of like private investments and rates of return iterations often modeled in connection with the valuation of FLP interests.

The consideration of substitution or alternative investments with similar level of risks bear upon the discount required of an investor from the net asset value of a typical FLP entity.

The Family Issue

No family functions perfectly. Disagreements and divorce also affect high net worth families, and when significant money is involved, disagreements and divorce lead to very expensive and time-consuming litigation. Situations such as siblings fighting over an inheritance, parents trying to instill middle-class values in their children, and ex-wives fighting over alimony often create tumult.

One aspect of an FLP is to assist high net worth families in controlling family wealth generationally, protecting it from creditors, former spouses, publicity, and theft. Often, the senior generation will maintain custodial control of the FLP assets via the powers of being the general partner(s) until their death.

During the parent's life, the most an heir is often benefited by ownership of an FLP limited partnership interest is through the distributions, if any, made by the FLP by action of the general partner(s).

In addition to lack of ownership control, the child (i.e., the limited partner) is often unable to sell its partnership interest, due to either numerous restrictions on transfers or lack of market liquidity as a privately held and risky, unattractive investment interest.

This lack of control and lack of marketability, among others, is one reason why large fortunes typically cause discontent within families. Where at one time there may have been mutually beneficial terms and actions within an FLP structure among family members, things change, and family issues can turn very quickly once cordial actions break down.

For example, in *Pritzker v. Pritzker*, 19-year-old daughter Liesel Pritzker filed a $6 billion lawsuit against her father Robert Pritzker and 11 older cousins, accusing them of looting her trust funds and those of her 21-year-old brother, Matthew. The action focused unwanted attention on deep divisions tearing apart the once obsessively private family worth an estimated $15 billion.[21]

"One aspect of an FLP is to assist high net worth families in controlling family wealth generationally, protecting it from creditors, former spouses, publicity, and theft."

If an FLP structure was initially involved providing some "structured" economic benefit to the daughter by virtue of the general partner (i.e., Robert Pritzker), one can be ensured those economic benefits would quickly evaporate and discontinue.

This structuring would leave the limited partner (i.e., Liesel Pritzker) with a noncontrolling, illiquid, and nonmarketable interest that would be taxed as if the limited partner had full rights and use of the asset.

If Ms. Pritzker now wanted to sell her FLP interest, would she expect 100 cents on the dollar? Or, would she expect to receive substantially lower than par value for the risks the buyer (defined in Revenue Ruling 59-60 as a hypothetical (i.e., third-party) buyer) is now assuming for lack of control and lack of marketability?

Conclusion

Long-standing interpretations of Section 2704 by the Tax Court, market-based transactions of similar investment interests, family dynamics, and business motivations for interfamily transfers support valuation discounts. The speculated Section 2704 to-be-proposed regulations will end up causing significant undue hardships on investors in FLPs.

Rather than issuing highly contentious, proposed regulations regarding Section 2704 in order to correct the poor behavior of some taxpayers (and their professional advisers, more importantly), the Service should initially consider releasing a Job Aid on the topic to encourage open debate.

A Job Aid is not an official Service position, but it represents the Service's current thinking and acts as a reference for Service reviewers.

A Job Aid on family-owned FLP interest transfers (similar to the Job Aid issued on DLOM in September 2009 and on S corporation tax affecting in October 2014) would provide clarity and understanding of the Service's stance without creating significant disputes between taxpayers, their advisers, and the Service's agents, saving the Service time and taxpayer money in attempting to pass and then properly enforce its regulations.

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Continued from page 6

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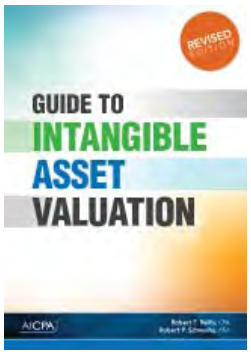
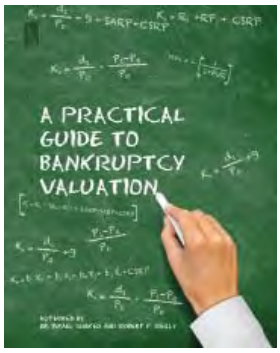
Valuation Textbooks Authored by Robert Reilly and Robert Schweihs





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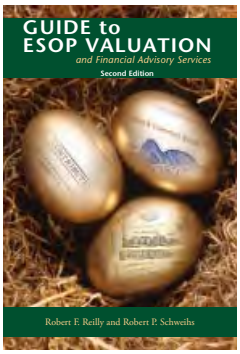

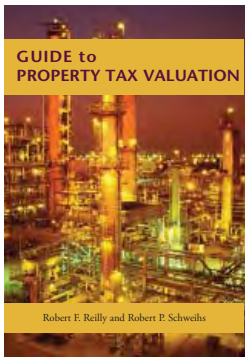

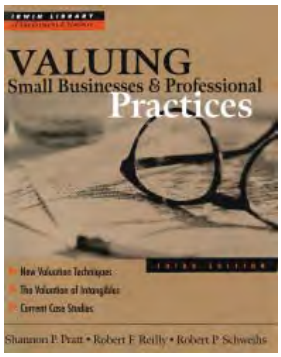

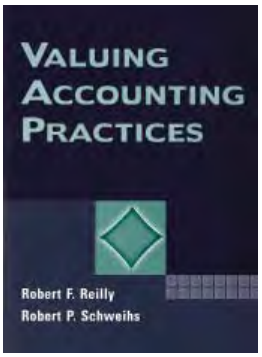

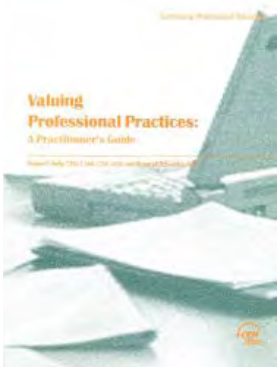

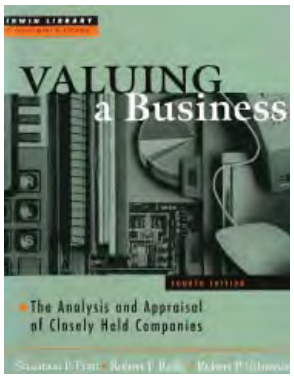

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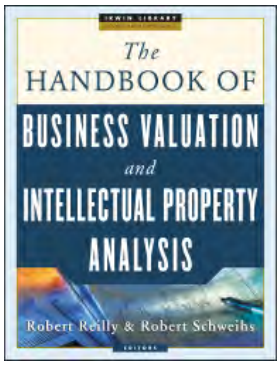

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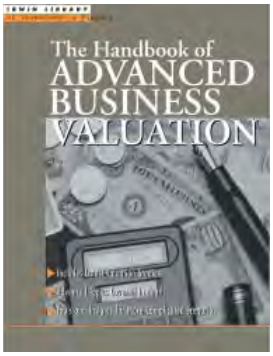

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Thought Leadership

Estimating Capital Expenditures and Depreciation Expense in the Direct Capitalization Method

Aaron M. Rotkowski and Matt C. Courtnage

Valuation analysts often rely on the income approach to estimate the value of operating companies for gift tax, estate tax, and generation-skipping transfer tax purposes. Two closely held business valuation variables that analysts frequently estimate when performing the business valuation income approach are (1) the projected capital expenditures and (2) the projected depreciation expense. These two valuation variables are related to one another and to other income approach valuation variables. This discussion considers the relative valuation impact of capital expenditures and depreciation expense, especially with regard to various projected growth rate assumptions.

Introduction

One of the most basic concepts in business or security valuation is that the value of a security is equal to the present value of the expected cash flow from the ownership of that security.

This valuation relationship is equally true whether the investment is a financial asset such as a U.S. Treasury bill, an ownership interest in real property, or an equity investment in an operating business enterprise.

This investment valuation relationship is often expressed by the following formula:

Formula #1:

$$V = \frac{I}{R}$$

where:

V = Value of the investment

I = Normalized "next period" income

R = Required rate of return

This simplified investment valuation formula is often referred to as the direct capitalization method. Along with the yield capitalization method, the direct capitalization method is a common income approach valuation method.

Using this valuation formula, an analyst can estimate the value of any investment or security if he or she knows (1) the investment's expected income and (2) the investor's expected rate of return on the investment.

Although this valuation formula only requires two inputs, estimating a value for each of those formula inputs is a complex—and often controversial—undertaking.

Every component in this valuation formula is worthy of its own discussion. This discussion focuses on the income portion of the direct capitalization method formula.

Specifically, this discussion presents best practices when estimating depreciation expense (often referred to as "depreciation" throughout this discussion) and capital expenditures. This discussion considers those cash flow components as part of the direct capitalization method.

This discussion focuses on the applicability of, the strengths of, and the weaknesses of, selecting various levels of capital expenditures (i.e., greater than, equal to, or less than) relative to the selected level of depreciation expense.

This discussion does not focus on estimating the specific levels of depreciation expense or capital expenditures to use in an income approach direct capitalization method valuation analysis.

Valuation Profession Treatment of Depreciation Expense and Capital Expenditures

Two surveys conducted in 2012 and 2013 demonstrate the degree to which valuation analysts vary on how to treat capital expenditures and depreciation expense.

In the 2012 survey, valuation analysts were asked whether depreciation expense should equal capital expenditures in a growth model: 44 percent said yes, 29 percent said no, and 27 percent said that those levels should depend on company growth and inflation.[1]

In the 2013 survey, analysts were asked how they typically handled capital expenditures and depreciation expense when estimating cash flow: 68 percent said they made them the same or very similar, 4 percent estimated capital expenditures less than depreciation expense, and 28 percent said they estimated capital expenditures materially greater than depreciation expense.[2]

Both surveys show that the consensus or default position among analysts is to set capital expenditures equal, or nearly equal, to depreciation expense in their models. It is fair to assume that the majority of these models assume some level of growth.

This position may be the analyst's default position. This is because certain U.S. courts have accepted valuations where depreciation and capital expenditures are offsetting, or because it is easier to perform and explain this adjustment than to justify why the amounts for depreciation expense and capital expenditures should differ.

It is the consensus opinion that the majority of operating companies subject to valuation for gift, estate, and generation-skipping transfer tax purposes warrant a positive long-term growth rate. A valuation model that assumes a 0 percent or negative long-term growth rate is typically only appropriate in extraordinary circumstances.

Facing a situation with zero or negative expected growth, business owners may:

1. achieve positive growth by adjusting operations,
2. scale back production or services offered to a point at which long-term growth will be positive, or
3. cease operations, either gradually over time or more abruptly.

This discussion provides information that analysts can consider when making such estimates, analyses, or assumptions.

Direct Capitalization Method Overview

The application of the direct capitalization method requires the analyst to apply several principles. The principles that are relevant to this discussion include the following:

1. The selected discount rate should be appropriately matched to the selected measure of income.
2. The selected growth rate should be appropriately matched to the selected measure of income.
3. Income should be normalized—that is, income should only include income or expense items that are expected to recur in perpetuity.

A detailed examination of these principles is outside the scope of this discussion. And, a detailed examination of these principles is not necessary since (1) these principles represent generally accepted valuation theory and (2) they are not controversial.

However, this discussion presents an overview of these three principles because they are relevant to the subsequent discussion about depreciation expense and capital expenditures.

Principle #1: Discount Rate and Income

In the direct capitalization formula, the selected discount rate (or rate of return) should be appropriately matched to the selected measure of income. The failure to properly match income with the discount rate is a fundamental flaw of the application of the direct capitalization method.

According to *Cost of Capital*, "A very common type of error in applying the income approach to valuation is to use a discount or capitalization rate that is not appropriate for the definition of economic income being discounted or capitalized. This general category of error has almost infinite variations."[3]

The appropriate discount rate is one that includes a rate of return for each component of the selected

Exhibit 1
Terminal Value Based on Alternative Direct Capitalization Rates

Present Value Discount Rate	12%	12%	12%	12%	12%
− LTG Rate	4%	3%	2%	1%	0%
= Direct Capitalization Rate	8%	9%	10%	11%	12%
Terminal Cash Flow (NCF)	100	100	100	100	100
÷ Direct Capitalization Rate	8%	9%	10%	11%	12%
= Indicated Value	1,250	1,111	1,000	909	833

measure of income. For example, if the selected measure of income includes a return from debt (i.e., it is estimated before the deduction of interest expense) and a return from equity, then the appropriate discount rate is one that considers the required rate of return from both debt capital and equity capital.

Likewise, if the income return is an after-tax return, then the discount rate should be an after-tax discount rate.

In the valuation of an operating company using the direct capitalization method, income is often estimated as subject company net cash flow to invested capital.

Net cash flow to invested capital (NCF) is typically calculated as follows:

Formula #2:

Net income
\+ Tax-affected interest expense
\+ Depreciation expense
– Capital expenditures
+/– Changes in net working capital
= NCF

When valuation analysts use Formula #2, they often think of depreciation expense and capital expenditures together. This is because depreciation expense is a function of capital expenditures.

In the direct capitalization method, capital expenditures should either:

1. exceed depreciation,
2. be equal to depreciation, or
3. be less than depreciation.

The appropriate discount rate based on the NCF formula presented in Formula #2 is the weighted average cost of capital (WACC) minus the estimated long-term growth rate of NCF (the "LTG rate").

In this example, the WACC is based on both:

1. the subject company's cost of equity capital and
2. its cost of debt capital.

The WACC is an appropriate discount rate for NCF because NCF includes a return on both equity capital and debt capital.

Based on the information above, and using more specific measures of income and rate of return, Formula #1 can be rewritten for an operating company as follows:

Formula #3:

$$Business\ Enterprise\ Value = \frac{Next\ Period\ NCF}{(WACC\ -\ LTG\ rate)}$$

Principle #2: LTG Rate and Income

In the direct capitalization method, the selected direct capitalization rate equals the selected discount rate (e.g., the WACC) minus the expected LTG rate of the selected income measure (e.g., NCF).

As evident from the direct capitalization formula, it is important to select an LTG rate that matches the selected income measure. This is important to reiterate because, in our experience, analysts often incorrectly select an LTG rate based on reference to factors other than the expected growth of the selected income measure.

For example, an analyst may select a 3 percent LTG growth rate. And, he or she may support this selected growth rate by citing historical growth in revenue, operating income, or net income.

Although such factors may be useful guideposts in an LTG rate analysis, they should not be relied on as proxies for the estimated LTG rate of NCF or another/different measure of income.

Another common inconsistency we have observed is the use of sensitivity tables that present the firm value in various scenarios where (1) income (i.e., NCF) is held constant and (2) the LTG rate changes (which causes the direct capitalization rate to change).

The potential error in such a sensitivity table is the assumption that the selected LTG rate is not related to the selected measure of income or the discount rate. This sensitivity table error often looks something like the data presented in Exhibit 1.

In fact, if one variable changes (i.e., the LTG rate), one would expect the other variables to change as well (i.e., NCF). For example, rapid growth is often

associated with increased risk and significant projected capital expenditures.

A subsequent section of this discussion revisits this exhibit and presents an alternative way to consider NCF, the LTG rate, and value.

Principle #3: Normalization of Income

One of the assumptions of the direct capitalization method is that the income will increase or decrease in perpetuity (i.e., forever) at a constant rate of growth.

Therefore, the appropriate level of income is some measure of normalized income. In order to normalize income, the analyst should exclude income and expenses that are not expected to recur.

According to *Cost of Capital*, the income that is capitalized "represents the long-term sustainable base level of economic income or a base from which the level of economic income is expected to grow or decline at a more or less constant rate."[4]

According to *Understanding Business Valuation*, "The objective in a single period capitalization method is to determine through analysis—and if necessary, adjustments—the level of benefits that are reflective of a *sustainable* level for the appraisal subject."[5]

As an example, let's assume that NCF in a direct capitalization method is estimated by reference to the company's three-year average net income. And, let's assume that the three-year average net income includes the results of an unprofitable subsidiary that was sold prior to the valuation date.

It would not be appropriate to include the results from that subsidiary in the normalized NCF of the subject company. This is because the company will not earn revenue or incur expenses related to that subsidiary in the future.

The valuation analyst will typically adjust for nonrecurring items such as this and calculate the NCF that he or she expects will recur in the future.

Other examples of nonrecurring income and expense items may include net operating loss carryforwards, gains on the sale of assets, litigation expense, restructuring expenses, and so on.

These normalization adjustments are especially important for capital expenditures and depreciation expense as these two variables can vary widely from year to year without any extraordinary events and through the normal course of business. Additionally, these variables are often fairly sizable relative to NCF.

We recognize that for certain periods, depreciation expense can exceed capital expenditures for a number of reasons. However, this unusual and often

temporary condition should not be modeled into a perpetuity model.

This is because, as discussed herein, the selected measure of income in a perpetuity model such as the direct capitalization method should be *normalized* income. The selected measure of income should not include income or expense items that are either temporary or not expected to recur in perpetuity.

Discounted Cash Flow and the Terminal Value

We frame this discussion in the context of the direct capitalization method. However, estimating depreciation expense and capital expenditures is important for the discounted cash flow (DCF) method.

The DCF method includes two components of income and value. The first component involves a projection of company results of operation for a discrete, multiyear period. The discrete cash flow projection is then converted to a present value.

The second component in the DCF method is the terminal value. The terminal value is "the present value of the stabilized benefit stream capitalized into the future,"[6] where the future represents all periods after the discrete projection period at a point in time where NCF is *normalized*.

The terminal value is often calculated using the Gordon growth model (GGM) formula. After estimating the terminal value, the analyst converts the estimated terminal value to a present value using an appropriate present value discount rate.

Similar to the direct capitalization method, the terminal value calculation in the DCF method typically assumes operations into perpetuity. The terminal value is an important component in the DCF method. This is because it can represent 75 percent or more of the total company value.[7]

In theory, a DCF method analysis should project out the cash flow for a length of time until the cash flow reaches a stable period at which an LTG rate can be applied. This would imply that depreciation expense and capital expenditures have also stabilized.

The GGM formula used to calculate the terminal value is fundamentally the same formula that is used to estimate value in the direct capitalization method described above.

The GGM formula is presented below.

Formula #4:

$$PV = (NCF_0 \times (1 + g)) \div (k - g)$$

where:

PV = Present value of the investment

NCF_0 = Net cash flow in the final discrete projection period[8]

g = Selected long-term growth rate

k = Selected cost of capital

In both (1) the direct capitalization model formula (i.e., Formula #1) and (2) the GGM formula (i.e., Formula #2), the next period income is divided by a risk-adjusted and growth-adjusted discount rate in order to estimate value.

Therefore, although we frame this discussion in the context of direct capitalization, the issues discussed herein relate to both the direct capitalization method and DCF methods where a terminal value is estimated using the GGM formula.

The next sections of this discussion focus on the following valuation variables:

1. Growth rate
2. Depreciation expense
3. Capital expenditures

Each of these variables has a significant impact on an overall valuation, whether via the direct capitalization method or the DCF method.

Growth Rate and Capital Expenditures

One of the most basic concepts of growth models, such as direct capitalization or the GGM formula, is that all of the valuation variables are related to each other. And, all selected valuation variables should be based on internally consistent variables.

Capital expenditures have a direct correlation to both growth and depreciation expense. Increased levels of capital expenditures should in turn lead to increased future growth. Likewise, increased capital expenditures will raise future levels of depreciation expense.

One way to think about capital expenditures is to break those outlays into two components:

1. Maintenance or replacement outlays
2. Growth-driven capital expenditures

Throughout this discussion, we consider maintenance capital expenditures as those expenditures required to maintain the existing size and capacity of a company. These capital expenditures do not include expenditures related to new capacity of an existing product line, a new product line, or other similar growth initiatives. And, when we refer to growth capital expenditures, we are referring to outlays that expand output capability.

Analysts often consider historical depreciation expense to be a good proxy for future capital expenditures. If a company consistently spent an amount equal to depreciation expense every year, the company's fixed asset level would remain unchanged. Any additional expenditure would result in an increased fixed asset base.

As long as a company earns a positive return on its capital investment, then capital expenditures in excess of maintenance capital requirements should result in some level of future growth.

The resulting boost to growth may be almost immediate, such as the purchase of equipment that increases capacity, or more delayed, such as the case with construction in progress or software development costs.

Projected capital expenditures should always reflect the expected LTG rate. Or conversely, a selected LTG rate should be supported by a certain level of capital expenditures and an assumed rate of return on that investment. If growth expectations are increased or decreased, then either capital expenditures need to be adjusted or new assumptions established regarding return on invested capital.

Assuming the rate of return on invested capital is held constant, then any change to the LTG rate assumption should require the analyst to adjust his or her assumptions for both capital expenditures and depreciation.

Nominal Growth and Real Growth Implications

Nominal values include the impacts of both inflation and real returns. Alternatively, real values are values that have been adjusted for the effects of inflation.

Nearly all company projections and discount rate data are presented in nominal terms. Therefore, our discussion of LTG rates is based on nominal LTG rates. In circumstances where the projected income and discount rate data are projected in real terms, then the selected LTG rate should be a real growth rate.

Based on this information, if we assume that the expected inflation rate in the United States is 3 percent, and the analyst selects an LTG rate of 3 percent in the direct capitalization method, then the analyst has selected:

1. a 3 percent *nominal* long-term growth rate and
2. a 0 percent *real* long-term growth rate.

And, if inflation is estimated at 3 percent, any selected LTG rate that is less than 3 percent results in negative real growth, and any selected LTG rate that is greater than 3 percent results in positive real growth.

Calculating the Reinvestment Rate

One reason that capital expenditures can exceed depreciation expense in a positive growth scenario is due to the need for capital to achieve those projections. The required capital can be estimated as the reinvestment rate.

For normalized NCF projections that include an assumption of a positive nominal LTG rate, equating capital expenditures and depreciation expense may be a flawed procedure.

When the estimated LTG rate is positive (i.e., any selected LTG rate greater than 0 percent—even if that growth rate results in negative or zero expected real growth) capital expenditures may exceed depreciation expense. This conclusion is true for any level of growth, real or nominal.

There are several generally accepted formulas to estimate a company's LTG rate and reinvestment rate. In addition to being useful, these formulas also illustrate the connected relationship between capital expenditures and the LTG rate (i.e., that the two variables increase or decrease in tandem).

According to the *Ibbotson SBBI Yearbook*,[9] a company's sustainable growth rate can be calculated as the company's reinvestment rate multiplied by its return on equity:

Formula #5:

$$g = b \times ROE$$

where:

g = LTG rate

b = Reinvestment rate

ROE = Return on equity (or return on investment)

In the growth formula presented above, the reinvestment rate is the amount of the company's earnings that are reinvested back into the subject business. This is also known as the plowback ratio, or reinvestment ratio. The plowback ratio measures how much a business is taking from its operating profit and investing back into the business.

Conceptually, it makes sense that a company that invests all of its annual cash flow back into the subject business as maintenance capital and growth capital will experience earnings growth at a faster rate than a company that distributes 100 percent of its annual cash flow to the company's owners.

Formula #5 is stated in a way to solve for growth. However, it can also be rewritten to solve for the reinvestment rate. Rewriting Formula #5 results in:

Formula #6:

$$b = g \div ROE$$

where:

b = Plowback ratio

g = LTG rate

ROE = Return on equity (or investment)

Formula #6 is useful in the direct capitalization method. This is because the reinvestment ratio—expressed as a percent—is essentially the amount of capital that the company needs to reinvest in order to achieve the estimated LTG rate.

The plowback ratio can be multiplied by NCF in order to estimate the amount of additional capital that is required to achieve the projected results.

As illustrated by Formula #6, as the selected LTG rate increases, so does the required plowback ratio (assuming a fixed ROE). Capital expenditures relative to depreciation expense should increase.

In order to confirm this formula, the analyst may:

1. estimate NCF by first assuming that depreciation expense and capital expenditures will offset,
2. select the appropriate LTG rate,
3. calculate the plowback ratio based on the selected LTG rate and other relevant valuation variables,
4. multiply the plowback ratio by NCF to estimate the company's growth capital,
5. reduce NCF by the estimated growth capital from step 4, and
6. capitalize the adjusted NCF from procedure 5 by the appropriate direct capitalization rate.

The reinvestment ratio is an important component of Formula #5 and Formula #6.

In the textbook *Investment Valuation: Tools and Techniques for Determining the Value of Any Asset*, Aswath Damodaran provides the following formula to estimate the reinvestment rate as it relates to EBIT growth:[10]

Formula #7:

$$Reinvestment\ Rate = \frac{(capital\ expenditures - depreciation\ expense + change\ in\ WC)}{EBIT\ (1 - t)}$$

where:

EBIT = Earnings before interest and taxes
t = Income tax rate
WC = Working capital balances

The formulas presented in this section illustrate how a company's distribution policy, expected level of capital expenditures, and other cash flow items are related to the company's LTG rate. Let's further consider how these factors are related using an example.

Let's assume that no change in working capital is expected, and that capital expenditures were expected to equal depreciation expense in the direct capitalization model. These variables would result in a numerator of zero based on Formula #6.

That would result in a reinvestment rate of zero, which in turn would result in zero operating growth.

That is, based on Formula #2, if depreciation expense and capital expenditures are expected to offset, then the appropriate LTG rate should be 0 percent.

The hypothetical company in the above example is assumed to only invest in a maintenance level of capital expenditures. These capital expenditures do not increase the net investment in the company's fixed assets. If one ignores the effects of inflation for the moment, one can see that depreciation expense and capital expenditures will be approximately equal on an annual basis and the LTG rate would equal zero.

Let's revisit Exhibit 1, which presented a sensitivity table that was based on constant income and changing direct capitalization rates. The error of this Exhibit 1 analysis is the failure to recognize that the company would need different levels of capital expenditures in order to achieve different levels of projected growth.

As was discussed in this section, the different levels of capital expenditures can be estimated using one of the plowback ratio formulas presented above (or by some other relevant formula to estimate the reinvestment ratio).

Exhibit 2 corrects the error in Exhibit 1 by incorporating growth capital into the NCF estimates. As illustrated by Exhibit 2, the only scenario where the indicated value based on the adjusted NCF equals the indicated value based on the unadjusted NCF is the no-growth rate scenario.

In a no-growth scenario the company does not need to invest in growth capital in order to realize its expected LTG rate.

There are factors other than capital expenditures that can result in positive growth, such as improvements to efficiency or inflationary spikes. However, positive LTG will typically require levels of capital expenditures above depreciation expense.

There may be cases in a stagnant industry where no nominal growth is a reasonable expectation. A no-growth scenario implies that the company would be experiencing negative real growth.

This situation could occur through some combination of:

1. a decline in output,
2. a decline in sales prices, or
3. an increase in expenses.

This scenario would perhaps justify estimating deprecation expense equal to capital expenditures. However, if output is projected to increase, and without material increases to efficiency, then normalized capital expenditures may still be greater than depreciation expense in a perpetuity model such as the direct capitalization method.

The Effects of Inflation on Depreciation and Capital Expenditures

Even in scenarios where a company is only projected to invest in a maintenance level of capital expenditures, it still may be appropriate to estimate capital expenditures greater than depreciation expense. This may be due to:

1. the effects of inflation,
2. the depreciable lives of the acquired assets, and
3. the selected depreciation method related to the acquired assets.

Exhibit 2
Terminal Value Based on Alternative Direct Capitalization Rates

Present Value Discount Rate	12%	12%	12%	12%	12%
– LTG Rate	4%	3%	2%	1%	0%
= Direct Capitalization Rate	8%	9%	10%	11%	12%
LTG Rate	4%	3%	2%	1%	0%
÷ Required on Investment [a]	16%	16%	16%	16%	16%
= Plowback Ratio	25%	19%	13%	6%	0%
Unadjusted NCF	100	100	100	100	100
× (1 – Plowback Ratio)	75%	81%	87%	94%	100%
Adjusted NCF	75	81	87	94	100
÷ Direct Capitalization Rate	8%	9%	10%	11%	12%
= Indicated Value Based on Adjusted NCF	938	900	880	855	833
Indicated Value Based on Unadjusted NCF [b]	1,250	1,111	1,000	909	833

[a] The required return on investment equal the discount rate plus 4%.
[b] From Exhibit 1.

Once the purchased assets are put into use, then depreciation expense related to those capitalized assets will commence. In general, the faster an asset is depreciated, the closer depreciation expense and capital expenditures will be in the NCF calculation.

In this section, we illustrate this point with an example.

The longer the depreciable life of the capitalized assets, the less of an impact any given year's capital expenditures will have on subsequent years of depreciation expense.

And, the smaller the impact a current year's expenditure has on subsequent years of depreciation expense, the larger the difference between depreciation and capital expenditures in the NCF calculation (where capital expenditures will exceed depreciation).

Additionally, the type of depreciation method will also affect the degree to which a given year's capital expenditure will affect depreciation expense in subsequent years. For instance, a double-declining balance depreciation method will lead to a greater impact on depreciation expense in the years immediately after a capital expenditure as opposed to later years.

Exhibit 3 provides a simple illustration of depreciation relative to capital expenditures. The exhibit assumes a 3 percent LTG rate, five-year asset lives, and a straight line depreciation method. The selected

Exhibit 3
The Impact of Inflation and Depreciation Method on Depreciation and Capital Expenditures

Normalized Capital Expenditure	$1,000
Long-Term Nominal Growth Rate [a]	3%
Depreciable Asset Life (years) [b]	5

	Year 1	Year 2	Year 3	Year 4	Year 5
Capital Expenditure	$1,000	$1,030	$1,061	$1,093	$1,126
Annual Depreciation	$200	$206	$212	$219	$225
Total Depreciation in Year 5					$ 1,062
Depreciation /Capital Expenditures Ratio in Year 5					94.3%

[a] The estimated growth rate relates to both NCF and capital expenditures
[b] Assumes straight-line depreciation method

LTG rate of 3 percent is equal to the analyst's estimate for inflation.

That is, the selected LTG rate includes positive nominal growth but no real growth (and no expectation of growth capital expenditures).

Based on the calculation presented in Exhibit 3, projected depreciation expense should equal approximately 94 percent of projected capital expenditures in the direct capitalization formula. This is because the most recent year of depreciation expense includes portions of prior years' capital expenditures.

As the projected maintenance capital expenditures continue to increase in cost due to inflation, they will continue to exceed depreciation expense on an annual basis.

Applying the same analysis as above, but varying the rates of assumed growth rate and depreciable lives as provided in Exhibit 4, results in depreciation to capital expenditure ratios of between 81 percent and 98 percent.

All else being equal, shorter depreciable lives and lower growth rates both increase the depreciation expense to capital expenditure ratio. Those results are presents in Exhibit 4.

Holding everything else constant, a straight line depreciation expense method will exacerbate the delta between depreciation and capital expenditures, while a sum of the digits method will minimize that delta. A double declining balance method will produce a delta somewhere between the other two methods.

Although the ratios of depreciation expense and capital expenditures in Exhibit 4 are relatively close to 100 percent, the impact of incorrectly estimating these variables on the concluded value using a direct capitalization method could produce significant variances in valuation estimates.

Let's assume that a valuation analyst is valuing an operating company using the direct capitalization formula.

Let's further assume that the analyst has estimated:

1. normalized capital expenditures at $20 million,
2. normalized depreciation expense equals capital expenditures (i.e., $20 million), and
3. a direct capitalization rate of 8 percent.

Let's further assume that the appropriate amount of normalized depreciation expense is actually 90 percent of capital expenditures. Based on these valuation variables, the analyst overstated depreciation expense by $2 million (calculated as 10 percent of $20 million). Therefore, the subject company value was overstated by $25 million (calculated as $2 million divided by 8 percent).

Based on the valuation variables applied in the direct capitalization formula, incorrectly assuming that depreciation expense will equal capital expenditures could result in a material overstatement of the subject company's value.

Even in a situation where no real growth is generated—and only nominal growth through the effects of inflation are expected—capital expenditures may exceed depreciation expense due to the timing lag between the two variables.

The Implied Projected Return on Assets

One reasonableness test of the projected depreciation expense and capital expenditures is to analyze the projected return on assets based on the selected valuation variables. This analysis is best illustrated using an example.

Let's assume that an analyst performs the direct capitalization method by estimating:

1. a positive nominal LTG rate for NCF and
2. offsetting amounts for depreciation expense and capital expenditures in the calculation of NCF.

Exhibit 4
Depreciation Expense as a Percentage of Capital Expenditures

	Nominal Growth Rate		
Depreciable Asset Life [a]	1%	3%	5%
5 Years	98.0%	94.3%	90.9%
7 Years	97.1%	91.7%	86.8%
10 Years	95.7%	87.9%	81.1%

[a] Assumes straight-line depreciation method

Based on the analyst studies presented earlier in this discussion, these are common valuation variables applied by analysts. In fact, these may be the default variables regarding growth and capital expenditures for many analysts when performing a direct capitalization method.

Next, let's assign some values to these valuation variables. Let's assume the following subject company facts and estimates:

1. NCF in the direct capitalization formula equals $100.
2. Capital expenditures and depreciation expense (which are components of the NCF calculation) are estimated at -$10 and $10, respectively.
3. Fixed assets (i.e., net investment) equal $1,000 as of the valuation date.
4. The estimated LTG rate is 3 percent.

Based on these valuation variables, one can calculate the following:

1. After one year, the net investment in fixed assets will equal $1,000 (calculated as beginning fixed assets of $1,000, plus capital expenditures of $100, minus depreciation expense of $100).
2. During the first year, the return on average assets will equal 10 percent (calculated as $100 cash flow divided by the average assets of $1,000).
3. Year two NCF will equal $103.
4. Year two ending fixed assets will equal $1,000.
5. During the second year, the return on average assets will equal 10.3 percent (calculated as $103 cash flow divided by the average assets of $1,000).

Since the direct capitalization method is a perpetuity model—that is, the income components are expected to increase or decrease at a constant rate forever—the trends that are observed above will continue every year into the future. That is, NCF will increase by 3 percent every year in perpetuity, and the company's investment in fixed assets will always remain at $1,000.

Based on (1) ever-increasing income and (2) a constant investment in fixed assets, the subject company's return on fixed assets will increase every year. In the example above, the return on fixed assets will increase by 3 percent per year.

The 3 percent increase is equal to the selected LTG rate of NCF. In 20 years, the subject company return on fixed assets will increase from 10 percent to 17.5 percent, or by 75 percent.

This trend begs the question: Is it reasonable to assume an ever-increasing return on fixed assets? The answer, of course, depends on the nature of the subject company, the industry it operates in, and the other variables in the direct capitalization method.

However, it is a rare set of circumstances where a company can increase its earnings without also increasing its investment in net fixed assets.

If an analyst projects (1) a positive nominal LTG growth rate and (2) depreciation expense to equal capital expenditures, then the analyst should be prepared to explain why he or she has implicitly assumed that the subject company can increase its profitability every year into the future.

Modelling Unusual Depreciation Expense and Capital Expenditures

As noted earlier, certain circumstances may dictate unusual levels of depreciation expense relative to capital expenditures—such as a company with a positive expected LTG rate that is projected to have greater levels of depreciation expense than capital expenditures for an extended period of time.

The reasons for this trend may include the following factors, among others:

1. A recent, large capital purchase
2. Wide time gaps in major capital expenditure outlays
3. Specific depreciation methods utilized
4. Sales of capital assets

In a direct capitalization model (or the terminal value calculation in the DCF method), the analyst is using a one-period normalized cash flow to derive a value estimate. It is important to account for any discrepancies between the normalized long-term assumptions and the known divergences from the long-term forecast that are expected to occur over the near term.

If either capital expenditures or depreciation expense are expected to temporarily diverge from their normalized long-term state, then the analyst may account for those differences in a way that recognizes the temporary nature of the difference.

A straightforward way to account for near-term/nonpermanent expectations would be to:

1. assume the normalized long-term cash flow projections in the direct capitalization model,
2. account for (i.e., estimate the value of) the temporary differences, and
3. add the resulting value adjustment to the direct capitalization value estimate.

The procedure 2 estimates should be based on a time period that represents as many years as necessary until a point in time at which it is reasonable

". . . it is important to note that when a valuation analyst inappropriately selects depreciation expense that is equal to capital expenditures . . . the analyst will overstate NCF and, therefore, will overstate the concluded value of the company."

to assume that capital expenditures and depreciation expense will have normalized.

The same procedure noted above can be applied to the terminal value calculation in the DCF method. Or, alternatively, the DCF method discrete projection period can be expanded to cover the years until capital expenditures and depreciation expense are expected to reach normalized levels. Both of these procedures should result in the same valuation conclusion.

Conclusion

In perpetuity models such as the direct capitalization method or the GGM formula, the standard valuation analyst procedure has been to calculate NCF by assuming depreciation expense and capital expenditures are equal. In this discussion, we have presented several reasons why this may not be appropriate.

First, if the analyst expects that the company will experience positive real growth (i.e., growth that is greater than the inflation rate), then the analyst should account for the source of that growth.

Often, the source of real growth is product line expansion, geographic expansion, or some other strategy that requires additional capital expenditures to execute.

Second, even if the analyst expects that growth will be somewhere between 0 percent and inflation (i.e., no real growth is projected), then the effects of inflation may still justify estimated capital expenditures that exceed depreciation expense in the NCF calculation.

Of course, there will also be legitimate reasons that depreciation expense will be equal to capital expenditures in the NCF calculation. The purpose of this discussion is not to suggest a rule that states capital expenditures must always exceed depreciation expense.

The purpose of this discussion is to present various pros and cons of making different projections regarding depreciation expense and capital expenditure in a perpetuity model.

However, it is important to note that when a valuation analyst inappropriately selects depreciation expense that is equal to capital expenditures—when in fact it would be more appropriate to selected depreciation expense that is less than capital expenditures—the analyst will overstate NCF and, therefore, will overstate the concluded value of the company.

As with all valuation variables estimated in the direct capitalization method or GGM formula, depreciation expense and capital expenditures should be estimated based on an analysis of all relevant factors.

Depreciation expense and capital expenditures should not be estimated simply based on the procedures performed in the past or based on how a plurality of analysts elects to estimate these valuation variables.

Notes:

1. "Did the DE Chancery Draw a 'Bright-Line Rule' Requiring Normalization of Capex/Depreciation in Terminal Values?," *BVWire* (October 31, 2012).
2. "Valuation Update: Webinar Poll Results Reveal Common Industry Practices," *Financial Valuation and Litigation Expert* (December 2013/January 2014): 1, 5.
3. Shannon P. Pratt and Roger J. Grabowski, *Cost of Capital*, 5th ed. (New YorK: John Wiley & Sons, 2014), 1187.
4. Ibid., 36–37.
5. Gary Trugman, *Understanding Business Valuation*, 4th ed. (New York: American Institute of Certified Public Accountants, Inc., 2012), 425.
6. Ibid., 428
7. Robert P. Reilly and Robert P. Schweihs, *The Handbook of Business Valuation and Intellectual Property Analysis* (New York: McGraw-Hill, 2004), 222.
8. NCF in the terminal projection period is often calculated as NCF in the final discrete projection period × (1 + selected LTG rate), as represented in the GGM formula presented.
9. *Ibbotson SBBI Yearbook* (Chicago: Morningstar, 2013), 51.
10. Aswath Damodaran, *Investment Valuation: Tools and Techniques for Determining the Value of Any Asset*, 3rd ed. (New York: John Wiley & Sons, 2012), 290.

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Measuring the Discount for Lack of Marketability for a Controlling, Nonmarketable Ownership Interest

Nathan P. Novak

A valuation analyst often has to value a controlling ownership interest in a closely held company for various taxation-related reasons. In such analyses, the analyst may initially conclude the value of a controlling, marketable ownership interest in the subject business entity. If this is the case, the analyst may have to apply a valuation adjustment to this initial value indication in order to conclude the value of the subject controlling, nonmarketable ownership interest. This discussion considers the factors that the analyst typically considers to measure the discount for lack of marketability (DLOM) related to the valuation of a controlling, nonmarketable level of value in the closely held business ownership interest.

Introduction

A valuation analyst ("analyst") often has to value closely held business ownership interests for gift tax, estate tax, and generation-skipping tax purposes. Often, the valuation subject is a controlling ownership interest in the closely held corporation or other type of business entity.

Depending on (1) the business valuation approaches and methods applied and (2) the benchmark valuation data used, the analyst may initially conclude the value of a controlling, marketable ownership interest in the subject closely held company. In that case, the analyst may have to apply a discount for lack of marketability (DLOM) valuation adjustment to the initial value indication in order to conclude the fair market value of the subject ownership interest.

The difference in the price that an investor is willing to pay for a liquid investment compared to an otherwise comparable illiquid investment may be material. This price difference is commonly referred to as the DLOM.

That is, the DLOM measures the difference in the expected price between:

1. a liquid asset (that is, the benchmark price measure) and
2. an otherwise comparable illiquid asset (typically, the valuation subject).

This discussion summarizes the following topics:

1. The considerations of investment liquidity and illiquidity
2. The various empirical and theoretical models that may be used to estimate the DLOM
3. The application of the DLOM to the valuation of a closely held business ownership interest
4. The factors that analysts consider in the selection of the DLOM

Consideration of Investment Liquidity

The terms *marketability* and *liquidity* are sometimes used interchangeably. However, there are differences between the two terms.

Barron's Dictionary of Business Terms defines marketability and liquidity as follows:

> **Marketability**. Speed and ease with which a particular security may be bought and sold. A stock that has a large amount of shares outstanding and is actively traded is highly marketable and also liquid. In common use, *marketability* is interchangeable with *liquidity*, but *liquidity* implies the preservation of value when a security is bought or sold.[1]

The investment attribute of marketability is not an either/or proposition. That is, there are varying degrees of marketability. There is a spectrum of marketability, ranging from fully marketable to fully nonmarketable.

An ownership interest of a publicly traded security can typically be converted into cash quickly, at low cost, and with certainty of price. This is the typical investment benchmark for a fully marketable investment.

At the other end of the marketability spectrum is an ownership interest in a closely held company that pays no dividends or other distributions, requires capital contributions, and limits ownership of the company to certain individuals.

Of course, there are a number of valuation-subject-specific positions in between these two extremes in the marketability spectrum.

Typical Reasons to Apply a Valuation Adjustment

In the U.S. public capital markets, a security holder can quickly sell most publicly traded securities at or near the last public trade price. The transactions typically occurs at a very small commission cost.

By contrast, the population of potential buyers for most closely held ownership interests is a small percentage of the population of potential buyers for publicly traded securities.

In fact, it may be illegal for an individual or an issuer to sell closely held securities to the general public without first registering the security offering with either:

1. the Securities Exchange Commission (SEC) or
2. the state corporation commission.

Such a security offering registration is an expensive and time-consuming process.

Besides the problems associated with selling a closely held business ownership interest, it is also difficult to hypothecate closely held securities. That is, the value of the closely held ownership interest is further affected by the unwillingness of banks and other lending institutions to accept such securities as loan collateral.

Because of these differences in the ability to sell or hypothecate a closely held ownership interest (compared to publicly traded shares), empirical evidence suggests that the DLOM valuation adjustment may be significant.

Baseline from Which to Apply the DLOM

In the valuation of a closely held business ownership interest, the analyst typically applies one or more of the three generally accepted business valuation approaches:

1. Market approach
2. Income approach
3. Asset-based approach

Depending on the individual valuation variables used, these three business valuation approaches may conclude value indications on either:

1. a controlling ownership interest level of value or
2. a noncontrolling ownership interest level of value.

In the typical application of the three business valuation approaches, the resulting value indications are typically concluded on a marketable ownership interest basis.

The amount of the DLOM depends on the facts and circumstances related to the subject closely held business ownership interest. This discussion summarizes the factors that an analyst typically considers in the measurement and selection of the DLOM.

Certain engagement-specific factors may also affect the appropriate magnitude of the DLOM. One engagement-specific factor that analysts consider is the particular level of value sought in a the valuation engagement.

This discussion focuses on measuring the DLOM in the context of a controlling ownership interest level of value.

Illiquidity for a Controlling Ownership Interest

Controlling ownership interests suffer from illiquidity in somewhat the same way as noncontrolling ownership interests. The marketability of an ownership interest—whether controlling or noncontrolling—is determined by the ability of the owner to quickly, at low cost, and with some degree of certainty, convert the ownership interest to cash.

Numerous judicial decisions have affirmed the application of a DLOM to the valuation of a controlling ownership interest.[2]

This valuation adjustment is a function of both:

1. the valuation methods and the variables used and
2. the level of value that is the objective of the subject valuation.

The value of a controlling ownership interest suffers some value decrement (compared to an otherwise comparable readily marketable security).

This value decrement is due to the following two factors:

1. The absence of a ready private placement market
2. Flotation costs (which would be incurred in achieving liquidity through a public offering)

The owner faces the following transaction risk factors when attempting to liquidate the controlling ownership interest:

1. An uncertain time horizon to complete the offering or sale
2. "Make ready" accounting, legal, and other costs to prepare for and execute the offering or sale
3. Risk as to the eventual sale price
4. Uncertainty as to the form (e.g., stock or cash) of transaction sale proceeds
5. Inability to hypothecate the subject equity interest
6. Investment banker or other brokerage fees

Risk factors one through five are summarized next. A summary of risk factor six—that is, investment banker or brokerage fees—is presented below in the Cost to Obtain Liquidity Studies discussion.

Investment Time Horizon Uncertainty

It may take months (or even years) to complete the offering or sale of a closely held controlling ownership interest. This uncertain (but considerable) time horizon contrasts with the principle of marketability.

The principle of marketability typically implies a short ownership-interest-for-cash conversion period.

"Make Ready" Costs

As discussed below (in the Cost to Obtain Liquidity Studies discussion), there may be substantial costs:

1. to prepare the company for sale and
2. to execute the company offering or sale.

A study published in 2000 concluded that underwriter costs alone typically represent 7 percent of the deal size in an initial public offering (IPO).[3] These underwriter costs do not include:

1. related auditing and accounting fees;
2. legal costs to draft documents, clear contingent liabilities, and negotiate warranties; and
3. business owner administrative costs.

In "The Cost of Going Public," Jay Ritter estimated these "other" transaction costs to be between 2.1 percent and 9.6 percent of the IPO proceeds.[4]

Expected Sale Price Uncertainty

The selling controlling ownership interest holder may not achieve the expected sale price because of many factors:

1. Overstatement of the business valuation on which the expected price is based
2. Occurrence of company events during the market exposure period that cause the sale price to decrease
3. Occurrence of market events during the market exposure period that cause the sale price to decrease
4. Lack of receptivity by capital markets to companies in the subject industry
5. Lack of receptivity by capital markets to the subject company

Expected Sale Proceeds Uncertainty

If the security sale proceeds are in a form other than cash, then the cash-equivalent transaction price

may be less than the reported transaction consideration.

Examples of the sale proceeds components that may have a cash equivalency value below face value include the following:

1. Restricted public stock
2. Seller-provided below-market financing
3. Future contingency payments
4. Future earn-out payments

Inability to Hypothecate the Ownership Interest

Banks are reluctant to lend based on a closely held ownership interest as collateral. Accordingly, it is difficult for the closely held company owner to borrow against the expected transaction sale price.

Investment Banker or Other Brokerage Costs

One consideration in the DLOM estimation of a controlling ownership interest is the cost to obtain liquidity studies. These DLOM studies only apply to the analysis of a controlling ownership interest. The cost to obtain liquidity studies are based on transactions of closely held controlling ownership interests.

The Cost to Obtain Liquidity Studies

The evidence that the analyst sometimes considers to support a controlling ownership interest DLOM is summarized below.

Transaction Costs

The various transaction costs related to the closely held controlling ownership interest sale include the following:

1. Auditing and accounting fees. These fees are incurred in preparing financial statements and related information for potential buyers and/or underwriters.
2. Legal costs. These costs are incurred in preparing documents, investigating contingent liabilities, and negotiating warranties.
3. Administrative costs (i.e., opportunity costs). These costs are related to the time committed by company owners and managers to deal with accountants, lawyers, potential buyers and/or their representatives.
4. Transaction and brokerage costs. These business broker, investment banker, or other transaction intermediary costs are sometimes referred to as "flotation costs." When these transaction costs are expressed as a percentage of the sale price, the percentage cost is referred to as the "gross spread."

In a study published in 1987, Jay R. Ritter analyzed the flotation costs typically incurred by the security issuer in an IPO.[5] These flotation cost data are summarized in Exhibit 1.

The Ritter study indicates that larger companies generally negotiate lower underwriting fees as a percent of the IPO gross proceeds.

More current flotation cost information is presented in a study conducted by Jay Ritter and Hsuan-Chi Chen published in 2000.[6]

In the "Seven Percent Solution," the authors examined the price spread (i.e., the underwriter price discount) from 3,203 firm commitment IPOs from January 1985 to December 1998. The selected IPO transactions all had domestic gross proceeds of at least $20 million before the exercise of the overallotment option.

Exhibit 2 summarizes the results from this Ritter and Chen study.

Ritter and Chen concluded that a significant number of IPOs were completed with a gross price spread of exactly 7 percent. In the 1985 to 1987 period, 23 percent of all IPOs had a 7 percent gross price spread. Of the IPOs analyzed in the 1998 to 1994 period, the amount of transactions with a 7 percent price spread increased to 60 percent.

For 1995 to 1998, 77 percent of all IPOs had a gross price spread of exactly 7 percent. Ritter and Chen observed that the price spread is larger for smaller companies.

This evidence indicates that a reasonable underwriter price discount for an IPO is 7 percent for companies with IPO gross proceeds exceeding $20 million.

PricewaterhouseCoopers LLP (PwC) published a study on IPO costs in September 2012.[7] PwC authors Martyn Curragh, Henri Leveque, and Neil Dahr examined both the costs a company incurs to make an IPO as well as the ongoing costs a company incurs to remain a publicly traded entity.

The PwC study analyzed over 380 IPO transactions between January 1, 2009, and June 30, 2012. The PwC study examined the following costs associated with the IPO transactions:

Exhibit 1
Ritter Study
IPO Flotation Cost Analysis

IPO Gross Proceeds [a] ($Million)	Number of Transactions Considered	Underwriting Price Discount [b] (%)	Other Flotation Expenses [c] (%)	Total IPO-Related Cash Expenses (%)
		Firm Commitment IPO Offers		
0.1–1.999999	68	9.84	9.64	19.48
2.0–3.999999	165	9.83	7.60	17.43
4.0–5.999999	133	9.10	5.67	14.77
6.0–9.999999	122	8.03	4.31	12.34
10.0–120.174175	176	7.24	2.10	9.34
All Offers	664	8.67	5.36	14.03
		"Best-Efforts" IPO Offers		
0.1–1.999999	175	10.63	9.52	20.15
2.0–3.999999	146	10.00	6.21	16.21
4.0–5.999999	23	9.86	3.71	13.57
6.0–9.999999	15	9.80	3.42	13.22
10.0–120.174175	5	8.03	2.40	10.43
All Offers	364	10.26	7.48	17.74

[a] Gross proceeds categories are nominal; no price level adjustments were made.
[b] The underwriting discount is the commission paid by the issuing firm; this is listed on the front page of the firm's prospectus.
[c] The other expenses figure comprises accountable and nonaccountable fees of the underwriters; cash expenses of the issuing firm for legal, printing, and auditing fees; and other out-of-pocket costs. These other expenses are described in footnotes on the front page of the issuing firm's prospectus. None of the expense categories include the value of warrants granted to the underwriter, a practice that is common with best-efforts offers.
Source: Jay R. Ritter, "The Costs of Going Public," *Journal of Financial Economics* (January 1987): 272.

Exhibit 2
Ritter and Chen Study
Analysis of the Number of IPOs, Gross Proceeds, and Gross Price Spread Percent

IPO Gross Proceeds:	$20 Million–$80 Million			$80 Million and Up			All IPOs in the Study		
IPO Transaction Date	Below 7%	Exactly 7%	Above 7%	Below 7%	Exactly 7%	Above 7%	Below 7%	Exactly 7%	Above 7%
1985–87	46%	26%	28%	76%	12%	12%	52%	23%	25%
1988–94	14%	75%	11%	90%	10%	0%	31%	60%	9%
1995–98	5%	91%	4%	71%	28%	1%	20%	77%	3%

1. Underwriter fees
2. Legal, accounting, and other fees directly attributable to the IPO

Exhibit 3 summarizes the PwC IPO cost study

The PwC study concluded that the average cost paid to the IPO underwriter ranged from 5.5 percent of gross proceeds to 6.9 percent of gross proceeds. The PwC study suggests a trend of decreasing costs as a percentage of gross IPO proceeds as the size of the IPO increases.

The PwC study quantified additional costs related to an IPO. It suggests that the total costs associated with an IPO, on a percentage of gross proceeds, is actually greater than the 5.5 percent to 6.9 percent demanded by the underwriter.

Each of the above-described cost to obtain liquidity studies concluded that larger companies can negotiate lower underwriter fees, as a percent of the IPO gross proceeds.

The PwC study presented evidence that reasonable underwriter fees range from approximately 5 percent to 7 percent, depending on the size of the IPO.

The PwC study also concluded that the additional costs associated with an IPO make the total costs, as a percentage of gross proceeds, greater than 5 percent to 7 percent.

The Ritter and Chen study presented evidence that reasonable underwriter fees are approximately 7 percent of the IPO gross proceeds. That study did not analyze companies with IPO gross proceeds of less than $20 million.

The Ritter study did analyze companies with IPO gross proceeds under $20 million, indicating costs of over 10 percent of the IPO proceeds for smaller transactions.

The seller of a closely held company may incur other costs in addition to:

1. the underwriter fees and
2. the "other costs" described above.

The Illiquidity for a Controlling Ownership Interest discussion above presented six factors that contribute to the controlling ownership interest DLOM.

These six factors relate to the following:

1. Uncertain investment time horizon risk
2. "Make ready" cost risk
3. Expected sale price risk
4. Expected sale proceeds risk
5. Inability to hypothecate the ownership interest
6. Investment banker or other brokerage fees.

"In order to measure the controlling ownership interest DLOM, analysts should consider all costs to liquidate such controlling ownership interests."

Only factor six, investment banker or other brokerage fees, is included in the 7 percent liquidity cost measured by Ritter and Chen, and the 5 percent to 7 percent liquidity cost measured by the PwC study.

In order to measure the controlling ownership interest DLOM, analysts should consider all costs to liquidate such controlling ownership interests.

Subject Company Risk

Another factor that may affect the controlling ownership interest DLOM is the subject company risk. Numerous studies conclude that the DLOM size is related to the stock price volatility (one measure for risk).

Exhibit 3
PwC Study
Analysis of the Number of IPOs, Gross Proceeds, and Costs Associated with IPOs

	IPO Costs ($ Millions)							
Gross Proceeds ($ Millions)	External Auditor Average	Legal Average	Printing Average	Registration/ Filing Average	Misc. Average	Underwriter Discount Average ($ Millions)	Underwriter Discount Average (%)	Average Total Costs ($ Millions)
0–50	0.6	1.0	0.2	0.1	0.2	2.0	6.9	4.1
51–100	1.0	1.5	0.3	0.2	0.4	5.1	6.8	8.5
101–200	1.0	1.6	0.3	0.2	0.5	9.4	6.6	13.0
201–300	0.9	2.1	0.4	0.3	0.7	15.2	6.3	19.6
300+	1.2	2.3	0.5	0.3	0.5	23.3	5.5	28.1

Numerous studies also attribute company size (another measure for risk) with the DLOM size.

Analysts generally agree that a large closely held company is a "safer" investment than a similar small closely held company, all other factors being equal. This conclusion is illustrated by comparing the expected rates of return on large-capitalization companies to small-capitalization companies.

Ibbotson Associates makes this comparison in the *Ibbotson SBBI 2015 Classic Yearbook*:

> One of the most remarkable discoveries of modern finance is that of a relationship between company size and return. . . . The relationship between company size and return cuts across the entire size spectrum. . . . Small-cap stocks are still considered riskier investments than large-cap stocks. Investors require an additional reward, in the form of additional return, to take on the added risk of an investment in small-cap stock.[8]

Large companies are perceived as safer investments than are small companies. This is because larger earnings typically enable a company to:

1. withstand downturns in the economy and the subject industry and
2. capitalize on growth opportunities.

Factors in addition to size can also affect the subject closely held company risk. The following list includes some of the factors that may affect subject company risk:

- Historical financial ratios
- Historical earnings trends/volatility
- Management depth
- Product line diversification
- Geographic diversification
- Market share
- Supplier dependence
- Customer dependence
- Deferred expenditures
- Lack of access to capital markets

Each of the above factors should be examined within the context of how they affect a controlling ownership interest investor.

The analyst typically considers how each factor affects the investor's ability to sell or liquidate the controlling ownership interest.

Summary and Conclusion

An analyst is often asked to value controlling ownership interests in closely held companies for various taxation-related reasons. Depending on (1) the valuation approach and valuation method applied and (2) the benchmark valuation variable date used, the analyst may conclude the value of a controlling, marketable ownership interest in the subject company.

In such an instance, the analyst may need to apply a valuation adjustment to conclude the value of a nonmarketable, controlling ownership interest in the subject company.

This discussion summarized the factors that analysts typically consider in order to measure the DLOM for a controlling ownership interest in a closely held business.

Notes:

1. John Downs and Jordan Elliot Goodman, eds., *Barron's Dictionary of Finance and Investment Terms*, 6th ed. (Hauppauge, NY: Barron's, 2003), 406.
2. See, for example: Estate of Dunn (T.C. Memo 2000-12), Estate of Jameson (T.C. Memo 1999-43), Estate of Dougherty (T.C. Memo 1990-274), and Estate of Maggos (T.C. Memo 2000-129).
3. Hsuan-Chi Chen and Jay Ritter, "The Seven Percent Solution," *The Journal of Finance* (June 2000): 1129.
4. Jay Ritter, "The Costs of Going Public," *Journal of Financial Economics* (January 1987): 269–281.
5. Ibid.: 272.
6. Chen and Ritter, "The Seven Percent Solution."
7. Martyn Curragh, Henri Leveque, and Neil Dhar, et al., "Considering an IPO? The Costs of Going and Being Public May Surprise You," PricewaterhouseCoopers LLP (September 2012), http://www.pwc.com/us/en/transaction-services/publications/cost-of-ipo-september-2012.jhtml (accessed December 4, 2014).
8. *Ibbotson SBBI 2015 Classic Yearbook* (Chicago: Morningstar, 2015), 99, 113.

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Measuring the Discount for Lack of Marketability for Noncontrolling, Nonmarketable Ownership Interests

Nathan P. Novak

Valuation analysts are often asked to value noncontrolling, nonmarketable ownership interests in closely held companies. These valuations may be performed for gift tax, estate tax, generation-skipping transfer tax, income tax, property tax, and other taxation purposes. Depending (1) on the valuation approaches and methods applied and on (2) the benchmark empirical data used, these analyses may initially conclude the valuation of a noncontrolling, marketable ownership interest. In such instances, analysts often have to apply a valuation adjustment to these initial (i.e., marketable) value indications in order to reach the final (i.e., nonmarketable) value conclusion. This discussion summarizes the various factors that analysts typically consider in the measurement of a discount for lack of marketability (DLOM) associated with a noncontrolling, nonmarketable closely held business ownership interest.

Introduction

Valuation analysts ("analysts") are often asked to value nonmarketable, noncontrolling ownership interests in closely held companies. These valuations may be performed for gift tax, estate tax, generation-skipping transfer tax, income tax, property tax, and other taxation purposes.

Depending on (1) the valuation approaches and methods applied and (2) the benchmark empirical data used, these analyses may initially conclude the valuation of the ownership interest on a noncontrolling, marketable, level of value.

In such instances, analysts often have to apply a valuation adjustment to these initial (i.e., incorrect level of value) value indications in order to reach the final (i.e., correct level of value) value conclusion.

This discussion summarizes the various factors that analysts typically consider in the measurement of a discount for lack of marketability (DLOM) associated with a noncontrolling, nonmarketable closely held business ownership interest.

The difference in value between a liquid business ownership interest compared to an otherwise comparable illiquid business ownership interest may be substantial. This value difference is often referred to as the DLOM.

This discussion summarizes the following gift-tax-related and estate-tax-related business valuation topics:

1. The concepts of business ownership interest liquidity and illiquidity
2. The various empirical models that analysts often use to estimate the DLOM
3. The application of the DLOM to the valuation of a closely held business ownership interest
4. The factors that influence the magnitude of the DLOM

"Typically, there is a spectrum of ownership interest marketability, ranging from fully marketable to fully nonmarketable."

Liquidity of the Subject Ownership Interest

The terms marketability and liquidity are sometimes used interchangeably. However, there are differences between these two terms.

Barron's Dictionary of Business Terms defines marketability and liquidity as follows:

> **Marketability**. Speed and ease with which a particular security may be bought and sold. A stock that has a large amount of shares outstanding and is actively traded is highly marketable and also liquid. In common use, *marketability* is interchangeable with *liquidity*, but *liquidity* implies the preservation of value when a security is bought or sold.[1]

For purposes of this discussion, the terms *marketability* and *lack of marketability* apply to a fractional ownership interest in a closely held business enterprise. The terms *liquidity* and *lack of liquidity* (or *illiquidity*) apply either to an overall business enterprise or to a controlling ownership interest in the business enterprise.

Typically, the attribute of marketability is not an either/or proposition. There are degrees of marketability. Typically, there is a spectrum of ownership interest marketability, ranging from fully marketable to fully nonmarketable.

An ownership interest of a publicly traded security can typically be converted into cash quickly, at a certain price, and at a low transaction cost. This is the typical benchmark for a fully marketable security.

At the other end of the marketability spectrum is an ownership interest in a closely held business entity that pays no dividends or other distributions, requires capital contributions, and limits ownership of the company to certain individuals.

Common Reasons to Apply a Valuation Adjustment

The population of potential buyers for most closely held company ownership interests is a small percentage of the population of potential buyers for most publicly traded securities.

In fact, typically it is illegal for an individual owner or for a company issuer to sell closely held securities to the general public without first registering the security offering with either the Securities Exchange Commission (SEC) or the state corporation commission.

Such a security offering registration is an expensive and time-consuming process. Furthermore, a noncontrolling stockholder cannot register closely held shares for public trading. Only the company itself can register its securities for public trading.

Besides the problems associated with selling closely held company ownership interests, it is also difficult for investors to hypothecate these securities. The value of closely held company ownership interests is further impaired by the unwillingness of banks and other lending institutions to accept such securities as loan collateral.

Benchmark from Which to Apply the Valuation Adjustment

In the gift tax or estate-tax-related valuation of a closely held company, analysts typically apply some combination of three generally accepted business valuation approaches:

1. Market approach
2. Income approach
3. Asset-based approach

Depending on (1) the individual business valuation variables used and (1) the individual business valuation methods used in the analysis, these three valuation approaches may conclude value indications on either:

1. a controlling ownership interest level of value or
2. a noncontrolling ownership interest level of value.

In the typical application of all three generally accepted business valuation approaches, the resulting value indications are typically concluded on a marketable ownership interest basis.

The magnitude of the specific DLOM depends on the facts and circumstances related to:

1. the subject closely held company and
2. the subject nonmarketable business ownership interest.

This discussion summarizes the factors that analysts typically consider in the measurement of a DLOM.

Analytical Models that May Be Used to Measure the DLOM

Analysts often consider two types of models to measure the appropriate level of the DLOM:

1. Empirical models
2. Theoretical models

Generally, the so-called empirical models use analyses that are based on empirical capital market transaction observations—rather than on theoretical economic principles.

Generally, the so-called theoretical models do not rely on actual capital market pricing evidence. Rather, theoretical models are based on fundamental microeconomic relationships.

Empirical Models

Empirical models rely on actual transactional data to provide evidence for estimating the amount of a DLOM.

There are two categories of studies that are often used to measure the DLOM for a noncontrolling ownership interest in a closely held company:

1. Studies of price discounts on the sales of restricted shares of publicly traded companies (i.e., the restricted stock studies)
2. Studies of price discounts on private stock sale transactions prior to an initial public offering (i.e., the pre-IPO studies)

These data are applicable to an initial—or unadjusted—value indication that represents the estimated price at which the subject ownership interest could be sold if it were registered and freely traded in a public stock exchange.

Theoretical Models

Theoretical models do not directly derive DLOM conclusions from transactional data. The theoretical models that may be used to estimate the DLOM for the valuation of a closely held company security generally fall into two categories:

1, Option pricing models (OPM)
2. Discounted cash flow (DCF) models

The Empirical Models

Restricted Stock Studies

Publicly traded companies often raise capital by completing a private placement of debt or equity securities. In an equity private placement, a company can issue either registered stock to general investors or unregistered (i.e., restricted) stock to an accredited investor.

Registered stock includes the shares of publicly traded companies that generally can be freely traded in the open market. Unregistered shares of stock are not registered for trading on a stock exchange.

When publicly traded companies issue restricted (unregistered) stock, the restricted stock is typically sold at a price discount compared to the price of the (registered) publicly traded stock.

Companies are willing to accept a price discount on the sale of restricted stock. This is because the time and cost of registering the new stock with the SEC would make the stock issuance/capital formation impractical.

These observed price discounts (i.e., public stock price compared to same company private stock price) indicate a DLOM. These stock price discount data are the basis for the restricted stock studies discussed below.

SEC Rule 144[2] governs the purchase and sale of stock issued in unregistered private placements. According to the SEC, "When you acquire restricted securities or hold control securities, you must find an exemption from the SEC's registration requirements to sell them in the marketplace. Rule 144 allows public resale of restricted and control securities if a number of conditions are met."[3]

The conditions mentioned in SEC Rule 144 relate to the following:

1. Investment holding period
2. Adequate current information
3. A trading volume formula
4. Ordinary brokerage transactions
5. Filing of a notice with the SEC

The investment holding period restrictions on the transfer of restricted stock eventually lapse, usually after a period ranging from six months to two years.[4]

At that point, the trading volume formula is typically the most restrictive sale condition of SEC Rule 144. The trading volume formula allows the securities to be "dribbled out" in the marketplace.

Depending on the size of the block of the subject securities, the dribble-out formula may require the investor to sell small portions of the securities over a multiyear period.

Rather than dribble out the sale of the restricted securities, the restricted stock owner can sell the securities in a privately negotiated transaction, subject to the Securities Act of 1933, Section 4(1) and Section 4(2).

Until 1995, restricted stock sale transactions had to be reported to the SEC. Since 1995, analysts have collected restricted stock sale transaction data from private sources.

Therefore, there are data available on the prices of private transactions in restricted securities. These data are sometimes used for comparison with prices of the same company unrestricted securities eligible for trading on the open market.

The conclusions of this restricted stock pricing evidence are discussed in the next section.

Restricted Stock Study Conclusions

Exhibit 1 summarizes 20 restricted stock studies (i.e., 18 total studies, with 2 studies split into 2 subsets) that cover several hundred transactions spanning the late 1960s through 2013.

These studies generally indicate a decrease in the average DLOM after 1990. The restricted stock transactions analyzed in the studies covering the 1968 to 1988 period (where the average indicated DLOM was approximately 35 percent) were generally less marketable than the restricted stocks analyzed after 1990 (where the average indicated DLOM was typically less than 25 percent).

Analysts typically attribute this indicated decrease in price discounts to the following factors:

1. The increase in volume of privately placed stock under SEC Rule 144(a)
2. The change in the minimum SEC-required holding period under Rule 144—from two years to one year—that took place as of April 29, 1997[5]

Exhibit 1
Restricted Stock Studies
Summary of Implied Level of DLOM

Restricted Stock Study	Observation Period of Study	Observed Average or Median Price Discount
SEC Overall Average	1966–69	25.8%
SEC Nonreporting OTC Companies	1966–69	32.6%
Milton Gelman	1968–70	33.0%
Robert R. Trout	1968–72	33.5%
Robert E. Moroney	1969–72	35.6%
J. Michael Maher	1969–73	35.4%
Standard Research Consultants	1978–82	45.0%
Willamette Management Associates	1981–84	31.2%
Hertzel and Smith [a]	1980–87	20.1%
William L. Silber	1981–88	33.8%
Bajaj, Denis, Ferris, and Sarin [b]	1990–95	22.2%
Johnson Study	1991–95	20.0%
Management Planning, Inc.	1980–96	27.0%
FMV Opinions, Inc. [c]	1980–14	19.3%
Greene and Murray	1980-12	24.9%
Columbia Financial Advisors, Inc.	1996–97	21.0%
Columbia Financial Advisors, Inc.	1997–98	13.0%
LiquiStat	2005–06	32.8%
Angrist, Curtis, and Kerrigan	1980–09	15.9%
Stout Risius Ross	2005–10	10.9%

[a] The observed price discount of 20.1 percent represents the overall average private placement discount reported in this study.
[b] This study attributes price discount to factors other than marketability (i.e., compensation for the cost of assessing the quality of the firm and for the anticipated costs of monitoring the future decisions of its managers).
[c] Represents results of the latest published study. The database is routinely updated and available for purchase at www.bvmarketdata.com.

Increased volume was the result of a Rule 144 amendment in 1990 that allowed qualified institutional investors to trade unregistered securities among themselves. By increasing the potential buyers of restricted securities, the marketability of these securities generally increased.

As it became easier to find a buyer for restricted securities after 1990, the average restricted stock price discount decreased.

The same trend occurred after the SEC-required holding period decreased from two years to one year in 1997.

On December 17, 2007, the SEC issued revisions to Rules 144 and 145.[6]

The revisions included shortening the holding period for restrict-

ed securities of issuers that are subject to the Securities Exchange Act of 1934 reporting requirements ("reporting companies") from one year to six months. "Under the amended Rules 144, after six months, if the issuer is a reporting company, . . . nonaffiliates may sell restricted securities without further limitations, including manner-of-sale or volume limitations."[7]

The holding period remains at one year for nonreporting issuers. This amendment became effective February 15, 2008.

It is important for analysts to compare the market for the subject closely held company with the market for restricted securities. If the expected holding period for the closely held company stock is two years or greater, it may be more supportable to select a DLOM based on the restricted stock studies conducted prior to 1990.

Alternatively, if the subject closely held stock is likely to be liquidated within six months or one year, the post-1990 studies may be more meaningful.

Another characteristic of the restricted stock studies is the wide range in price discounts observed within each study. Although the average price discounts calculated in the restricted stock studies are similar, the range of price discounts observed in each study was large, ranging from a price premium to price discounts approaching 90 percent.

One explanation for the wide range in price discounts is the myriad of company-specific and security-specific factors that affect the DLOM. While a DLOM is clearly indicated from the studies, it is up to the analyst to consider how the subject interest relates to the price discounts observed in the restricted stock studies.

Restricted shares of public stock may not (temporarily) be traded directly on a stock exchange. However, in a short time period, the investor has certainty that the trading restrictions will lapse. In contrast, the stock of a closely held company may never be traded on a public stock exchange.

The prospect of any efficient marketability is much lower for closely held company shares compared to restricted public company shares.

Therefore, the appropriate level of the DLOM related to closely held ownership interests may be greater than the price discounts concluded by restricted stock studies.

The Pre-IPO Studies

The second type of empirical analysis is the pre-IPO study. A pre-IPO study examines sale transactions in the stock of a closely held company that has subsequently achieved a successful IPO.

In a pre-IPO study, the DLOM is quantified by analyzing the difference between:

1. the public market price of the IPO and
2. the private transaction price at which a stock was sold prior to the IPO.

The following discussion summarizes three pre-IPO studies.

Emory Studies

A number of studies were conducted under the direction of John D. Emory, currently president of Emory & Co. in Milwaukee, Wisconsin.[8]

These studies covered various time periods from 1980 through 2000.[9]

The various Emory studies excluded the following types of companies:

1. Development stage companies
2. Companies with a history of real operating losses
3. Companies with an IPO price less than $5 per share
4. Foreign companies
5. Banks, saving and loans, real estate investment trusts, and utilities

Except for the 1997 through 2002 study, Emory used the same methodology for the studies. The 1997 through 2002 study focused on sale transactions of common and convertible preferred stock, and did not exclude companies on the basis of financial strength.

The observations in each study consisted of companies with an IPO in which Emory's firm either participated or received a prospectus. The prospectus for each of the 4,088 offerings was analyzed to determine the relationship between:

1. the IPO price and
2. the price at which the latest private transaction took place (up to five months prior to the IPO).

The mean and median price discounts from all of the transactions analyzed in the Emory pre-IPO studies equal 46 percent and 47 percent, respectively.[10] The fact that these price discounts are greater than the restricted stock study price discounts seems reasonable. The pre-IPO stock

sales occurred when there was not an established secondary market for the subject stock.

Exhibit 2 summarizes the results of the Emory studies.

Valuation Advisors Studies

Valuation Advisors, LLC (VA), maintains a database that includes over 3,500 pre-IPO transactions that occurred within two years of an IPO.[11]

These transactions are arranged into five time periods: four 3-month intervals for the 12 months immediately before the IPO, and a single period for the time frame from one to two years before the IPO. The transactions are also arranged by type of security (i.e., stock, convertible preferred stock, or option).

VA performed a pre-IPO study for each year between 1995 and 2012. Exhibit 3 on the following page summarizes the results of the VA studies.

Willamette Management Associates Studies

Willamette Management Associates (WMA) prepared 18 pre-IPO studies covering the period of 1975 through 1997 and an additional study covering the five years 1998 through 2002. As in the previous studies, the 1998–2002 study included only private market stock sale transactions that were considered to be on an arm's-length basis.

The transactional data analyzed in the 1998–2002 WMA pre-IPO study included the following:

1. Sales of closely held stock in private placements
2. Repurchases of treasury stock by the closely held company

All transactions involving the granting of employee, executive, or other compensation-related stock options were eliminated from consideration in the 1998–2002 study. All transactions involving stock sales to corporate insiders or other related parties were eliminated from consideration in the 1998–2002 study.[12]

Due to the small sample size of identified transactions in 2001 and 2002, the data from those years were excluded from the analysis.

The results of the WMA studies are summarized in Exhibit 4. In most cases, the WMA pre-IPO average price discounts were greater than the restricted stock average price discounts.

One explanation for this result is the fact that—unlike pre-IPO transactions—restricted stock transactions involve companies that already have an established public trading market.

Pre-IPO Study Conclusions

The pre-IPO studies cover hundreds of transactions over more than 30 years. Price differences between private transaction prices and public market prices varied under different market conditions, ranging from about 40 to 60 percent (after eliminating the outliers).

Pre-IPO studies provide relevant evidence of the DLOM for privately owned securities. This is because companies in the pre-IPO studies more closely resemble privately held securities to which the DLOM is being applied. The pre-IPO studies are the only DLOM studies that involve transactions in shares of privately owned companies.

Exhibit 2
Emory Pre-IPO Studies
Indicated Level of DLOM Results

Pre-IPO Study	Number of Prospectuses Reviewed	Number of Qualifying Transactions	Indicated Price Discount	
			Mean	Median
1980–1981	97	12	59%	68%
1985–1986	130	19	43%	43%
1987–1989	98	21	38%	43%
1989–1990	157	17	46%	40%
1990–1991	266	30	34%	33%
1992–1993	443	49	45%	43%
1994–1995	318	45	45%	47%
1995–1997	732	84	43%	41%
1997–2000 [a]	1,847	266	50%	52%

[a] This is an expanded study. The expanded study focused on sale transactions of common and convertible preferred stock, and did not exclude companies on the basis of their financial strength.
Note: The results above are from "Underlying Data in Excel Spreadsheet for 1980–2000 Pre-IPO Discount Studies, as Adjusted October 10, 2002," located at www.emoryco.com/valuation-studies.shtml.

The Theoretical Models

There are two types of theoretical DLOM measurement models:

1. OPMs
2. DCF models

Exhibit 3
Valuation Advisors Pre-IPO Study
Indicated Median DLOM Results

	Period before IPO in Which Transaction Occurred					
IPO Year	0–3 Months	4–6 Months	7–9 Months	10–12 Months	1–2 Years	Number of Transactions
1995	37.82%	28.62%	60.40%	50.33%	60.64%	34
1996	30.83%	52.97%	56.37%	69.38%	71.81%	270
1997	34.18%	50.00%	67.12%	76.01%	80.00%	212
1998	23.35%	46.67%	68.93%	71.41%	71.91%	212
1999	30.77%	53.89%	75.00%	76.92%	82.00%	694
2000	28.70%	45.08%	61.51%	68.92%	76.64%	653
2001	14.74%	33.17%	33.38%	52.06%	51.61%	115
2002	6.15%	17.33%	21.88%	39.51%	55.00%	81
2003	28.77%	22.30%	38.36%	39.71%	61.37%	123
2004	16.67%	22.68%	40.00%	56.25%	57.86%	334
2005	14.75%	26.10%	41.68%	46.11%	45.45%	296
2006	23.47%	20.69%	40.23%	46.51%	56.27%	264
2007	12.67%	32.55%	43.69%	56.00%	54.17%	459
2008	20.00%	24.21%	45.85%	52.17%	41.18%	41
2009	6.16%	31.85%	26.82%	41.00%	34.87%	108
2010	15.81%	29.89%	44.42%	47.54%	51.88%	358
2011	23.27%	34.62%	43.26%	50.78%	62.10%	281
2012	18.86%	24.07%	28.90%	35.48%	44.78%	292
1995–2012 Average	21.50%	33.15%	46.54%	54.23%	58.86%	
2008–2012 Average	16.82%	28.93%	37.85%	45.39%	46.96%	

Source: Brian K. Pearson. "Valuation Advisors' Lack of Marketability Discount Study™," *Business Valuation Resources Teleconference*, August 23, 2007 (1995–2006); Valuation Advisors database (2007–2012).

Option Pricing Models

OPMs are based on the premise that the cost to purchase a stock option is related to the DLOM. The following discussions summarize four DLOM studies that rely on option-pricing theory.

Chaffe Study

David B.H. Chaffe III authored a 1993 study in which he related the cost to purchase a European put option[13] to the DLOM. Chaffe concluded that "if one holds restricted or non-marketable stock and purchases an option to sell those shares at the free market price, the holder has, in effect, purchased marketability for those shares. The price of that put is the discount for lack of marketability."[14]

Chaffe relied on the Black-Scholes option pricing model to estimate the option price.

The inputs in the Black-Scholes model are as follows:

1. Stock price
2. Strike price
3. Time to expiration
4. Interest rate
5. Volatility

In the Chaffe model, the stock price and strike price equal the marketable value of the private company stock as of the valuation date; the time to expiration equals the time the securities are expected to remain nonmarketable; the interest rate is the cost

Exhibit 4
Willamette Management Associates Pre-IPO Studies
Indicated Level of DLOM Results

Time Period Analyzed	Number of Companies Analyzed	Number of Transactions Analyzed	Standard Mean Price Discount	Trimmed Mean Price Discount [a]	Median Price Discount
1975–78	17	31	34.0%	43.4%	52.5%
1979	9	17	55.6%	56.8%	62.7%
1980–82	58	113	48.0%	51.9%	56.5%
1983	85	214	50.1%	55.2%	60.7%
1984	20	33	43.2%	52.9%	73.1%
1985	18	25	41.3%	47.3%	42.6%
1986	47	74	38.5%	44.7%	47.4%
1987	25	40	36.9%	44.9%	43.8%
1988	13	19	41.5%	42.5%	51.8%
1989	9	19	47.3%	46.9%	50.3%
1990	17	23	30.5%	33.0%	48.5%
1991	27	34	24.2%	28.9%	31.8%
1992	36	75	41.9%	47.0%	51.7%
1993	51	110	46.9%	49.9%	53.3%
1994	31	48	31.9%	38.4%	42.0%
1995	42	66	32.2%	47.4%	58.7%
1996	17	22	31.5%	34.5%	44.3%
1997	34	44	28.4%	30.5%	35.2%
1998	14	21	35.0%	39.8%	49.4%
1999	22	28	26.4%	27.1%	27.7%
2000	13	15	18.0%	22.9%	31.9%

NA = Not applicable
[a] Excludes the highest and lowest deciles of indicated discounts.
Source: Pamela Garland and Ashley Reilly, "Update on the Willamette Management Associates Pre-IPO Discount for Lack of Marketability Study for the Period 1998 Through 2002," *Insights* (Spring 2004).

of capital; and, volatility is a judgmental factor based on volatility of guideline publicly traded stocks.

To apply an OPM to a private company, each of these variables is determined. Some variables, such as the interest rate and strike price, are relatively easy to input. Other variables, such as the holding period and volatility, are more difficult.

According to Chaffe, the volatility for small privately owned companies is likely to be 60 percent or greater. Chaffe reached this conclusion based on the volatility for small public companies that were traded in the over-the-counter market.

According to the study, the appropriate DLOM for a privately held stock with a two-year required holding period and a volatility between 60 percent and 90 percent is between 28 percent and 41 percent.

According to Chaffe, "considering that volatility for shares of most smaller, privately held companies fit the 'VOL 60%-70%-80%-90%' curves, a range of put prices of approximately 28% to 41% of the marketable price is shown at the two-year intercept. At the four-year intercept, these ranges are 32% to 49%, after which time increases do not substantially change the put price."[15]

Chaffe indicated that his findings were downward biased due to the reliance on European options in the model. Chaffe concluded that his findings should be viewed as a minimum applicable DLOM.

Longstaff Study

Francis A. Longstaff conducted a study that relies on stock options to estimate the DLOM.[16] While Chaffe based his study on avoiding losses, Longstaff based his study on unrealized gains. Another difference between the two studies is that the Longstaff study provides an estimate for the upper limit on the value for marketability.

The Longstaff study is based on the price of a hypothetical "lookback" option.[17]

The Longstaff study assumes an investor has a single-security portfolio, perfect market timing, and trading restrictions that prevent the security from being sold at the optimal time. The value of marketability, based on these assumptions, is the payoff from an option on the maximum value of the security, where the strike price of the option is stochastic.

Exhibit 5 on the next page summarizes the Longstaff study results.

For a five-year holding period and 30 percent standard deviation, the indicated DLOM is over 65 percent. Longstaff analyzed securities with a volatility between 10 percent and 30 percent because "this range of volatility is consistent with typical stock return volatilities."[18]

However, small stocks (such as those traded over the counter and analyzed by Chaffe) typically have greater volatility.

With volatility estimates greater than 50 percent, the Longstaff study indicated DLOM exceeds 100 percent. Some analysts have suggested that the percentage result from the Longstaff model (and other OPMs) is actually a price premium and not a price discount.

Professor Ashok Abbott wrote that, "Often, however, the value of a put option premium, estimating the cost of liquidity, is presented incorrectly as the discount for lack of liquidity. This is similar to the merger premium being treated as a discount for lack of control. Neglecting to convert the option premium to the applicable discount creates the illusion that the estimated discounts are greater than 100%, an impossible solution."[19]

Martin Greene wrote, "Frequently, appraisers compute the option and assume their result is a discount. In reality, the models produce a premium, which must then be converted to a discount."[20]

There is not universal agreement as to whether the OPM analyses produce a price premium or a price discount. Analysts who rely on the OPM analyses should consider how to use the studies to estimate the DLOM.

Finnerty Study

John D. Finnerty conducted an option-pricing study that "tests the relative importance of transfer restrictions on the one hand and information and equity ownership concentration effects on the other in explaining private placement discounts."[21]

The Finnerty option-pricing study is an extension of the Longstaff study. Unlike Longstaff, Finnerty did not assume that investors have perfect market timing ability. Instead, Finnerty modeled the DLOM as the value of an average strike put option.

In addition to analyzing stock options, Finnerty analyzed 101 restricted stock private placements that occurred between January 1, 1991, and February 3, 1997. The Finnerty private placement study concluded price discounts of 20.13 percent and 18.41 percent for the day prior to the private placement and for 10 days prior to the private placement, respectively.

With regard to his option-pricing study, Finnerty concluded that his model:

> calculates transferability discounts that are consistent with the range of discounts observed empirically in letter-stock private placements for common stocks with volatilities between δ = 30 percent and δ = 70 percent but the implied discounts are greater than (less than) those predicted by the model for lower (higher) volatilities.[22]

Finnerty reported the following observations about the importance of dividends, volatility, and the DLOM:

> My model implies that when the stock price volatility is under 30 percent, the appropriate discount is smaller than the customary discount range of about 25 percent to 35 percent. For example, when δ is between 20 percent and 30 percent and there is a two-year restriction period, the proper discount is in the range from 15.76 percent to 20.12 percent for a non-dividend-paying stock and in the range from 11.50 percent to 15.96 percent for a stock yielding 3.0 percent. The halving of the initial restriction period under Rule 144 since February 1997 has roughly halved the transferability discount.[23]

Exhibit 5
Longstaff Study
Upper Bounds for the Level of DLOM Percentage

Marketability Restriction Period	Standard Deviation = 10%	Standard Deviation = 20%	Standard Deviation = 30%
1 Day	0.421	0.844	1.268
5 Days	0.944	1.894	2.852
10 Days	1.337	2.688	4.052
20 Days	1.894	3.817	5.768
30 Days	2.324	4.691	7.100
60 Days	3.299	6.683	10.153
90 Days	4.052	8.232	12.542
180 Days	5.768	11.793	18.082
1 Year	8.232	16.984	26.276
2 Years	11.793	24.643	38.605
5 Years	19.128	40.979	65.772

Long-Term Equity Anticipation Securities (LEAPS) Studies

In September 2003, Robert Trout published a study analyzing LEAPS and the DLOM.[24]

Ronald Seaman updated the Trout LEAPS study several times—the most recent update was in September 2013.[25]

Each of these LEAPS studies was conducted using a similar research logic and research design. The following discussion summarizes these studies.

A long-term equity anticipation security is essentially a long-term stock option that offers price protection for up to two years into the future. Therefore, an investor who desires protection against stock price declines can purchase a LEAPS put option.

The LEAPS studies examined the cost of buying LEAPS put options and concluded that the cost of the LEAPS put option divided by the stock price indicates the DLOM.

Trout examined nine LEAPS as of March 2003 with options expiring January 2005. The nine LEAPS

were for large companies with actively traded securities.[26]

According to Trout, "The data concerning the relative cost of puts as an insurance premium indicate an insurance premium cost equal to about 24 percent of the price. This finding suggests that the minimum discount that one should assign for the lack of marketability of holding privately held stock is at least 24 percent."[27]

The 2013 Seaman study updated and extended the Trout study through November 2012. The Seaman study considered the relationship between the price of the LEAPS (i.e., the price discount) and the following variables:

1. Company size
2. Company risk
3. Latest year profit margins
4. Latest year return on equity
5. Company industry

The Seaman study concluded the following:

1. Company size: Revenue size has a major effect on the cost of price protection with smaller levels of revenue associated with larger discounts.
2. Company risk: Company risk has a large effect on discounts, with higher risk companies, as measured by a company's beta, associated with a larger discount.
3. Latest year profit margin: Company profitability has a mild (but not a major) effect on marketability discounts.
4. Return on equity: The company's latest year return on equity has some effect on discounts particularly at the lower end of returns. For positive returns on equity, there is a minor effect on discounts.
5. Industry: The size of the discount varies by industry, but the discounts vary even more by the individual company.[28]

The Seaman study presented the following observation with regard to the cost of price protection:

> [T]he costs of price protection are not constant but vary significantly over time. Economic conditions in November 2008 (recession) caused discounts to double or more over the August 2006 period. By November 2009 economic conditions had moderated. The costs of price protection had gone down by about one-third but were still from 30% to 50% above August 2006 levels.[29]

The LEAPS studies concluded that the observed DLOMs are appropriately viewed as benchmark minimum price discounts when applied to the valuation of privately held companies.

This LEAPS study conclusion is based on the following observations:

1. The underlying securities on which the LEAPS were based are often much larger than the privately held subject company.
2. The underlying securities on which the LEAPS were based are marketable.
3. The LEAPS themselves can be sold at any time during the holding period.
4. There is a known liquidity event (i.e., the sale of the underlying security) for LEAPS.

Option Pricing Model Study Conclusions

The OPM studies discussed above indicate similar price discounts to the empirical studies discussed previously. In the Chaffe, Longstaff, and Finnerty studies, the appropriate DLOM for a privately held company (given certain volatility assumptions) reaches 65 percent.

In the LEAPS studies, the price discount is much lower, but the authors conclude that the indicated price discount represents a minimum DLOM.

Because of their nature, OPM studies generally only consider the factors that affect option pricing: holding period and volatility. Although other factors are considered in the OPMs, the holding period and the volatility factors have the greatest impact on the option prices.

Therefore, OPM studies may understate the measurement of the DLOM. This is because OPM studies ignore other factors that may reduce the marketability for privately held securities (e.g., contractual transferability restrictions).

Basing the size of the DLOM on the two OPM factors appears reasonable. The holding period relates to the duration of time restricted stock must be held and risk relates to volatility. As the restricted stock studies indicate, the longer the required holding period, the greater the price discount a buyer expects.

Volatility is directly related to the DLOM. When an investor owns a security that is restricted from trading, that investor assumes the risk of:

1. not being able to sell the investment if the value begins to decline and
2. not being able to sell the investment to reallocate funds to another investment.

The first risk factor is affected by highly volatile stocks. As volatility increases, the risk of stock price

depreciation increases. As volatility increases, the risk related to holding a nonmarketable security likewise increases.

Due to these factors, the OPM studies provide a general methodology for analyzing the DLOM. These option pricing studies make several contributions to the empirical research referenced above.

The Discounted Cash Flow Models

The DCF method is based on the principle that value equals the present value of future income.

Z. Christopher Mercer and Travis W. Harms described how the DCF model relates to the DLOM:

> Quantitative analyses therefore estimates the value of illiquid interests based on the expectation of benefits (distributions or dividends and proceeds of ultimate sales) over relevant expected holding periods using appropriate discount rates to equate with present values. The process of doing this analysis, in the context of valuing a business at the marketable minority interest level, determines the applicable marketability discount.[30]

The following discussion summarizes two studies that rely on the DCF method.

The Quantitative Marketability Discount Model (QMDM)

Developed by Z. Christopher Mercer, the QMDM is a shareholder-level DCF model that uses a quantitative analysis to calculate the DLOM.

The QMDM calculates the DLOM based on:

1. the expected growth rate in the subject company value,
2. the expected interim cash flow,
3. the expected holding period, and
4. the required holding period return.

In the book, *Quantifying Marketability Discounts*,[31] Mercer provides guidance with regard to estimating these four factors.

In the application of the QMDM, the analyst values the subject company at the entity level, resulting in a valuation as if the security was readily marketable. Next, the analyst estimates shareholder value. The shareholder value represents the nonmarketable value of the subject security.

To calculate the shareholder value, the analyst increases the value of the subject company by the growth rate during the expected holding period.

Next, the analyst discounts the future company value using the required holding period return. Then, the analyst adds the present value of the dividend stream received during the holding period to this present value.

The resulting value equals the shareholder value. The calculation of one minus the ratio of shareholder value to enterprise value equals the DLOM.

The DLOM measured using the QMDM model is highly subject to the model inputs. In the *Estate of Weinberg v. Commissioner*, the Tax Court noted that, "slight variations in the assumptions used in the model produce dramatic differences in the results."[32]

In the *Estate of Janda v. Commissioner*, the Tax Court was concerned with the magnitude of the DLOM calculated using the QMDM model. The Tax Court noted, "We have grave doubts about the reliability of the QMDM model to produce reasonable discounts, given the generated discount of over 65%."[33]

Tabak Model

The Tabak model is a DCF model used to estimate the DLOM based on the capital asset pricing model (CAPM).

The Tabak model "focuses on the extra risks imposed on the owner of a security or interest in a business enterprise, and not on the lack of access to capital. In brief, the theory uses market data on the additional return that investors require in order to hold a risky asset, measured by the equity risk premium, to extrapolate the extra return that the holder of an illiquid asset would require."[34]

Discounted Cash Flow Model Conclusions

The DCF models provide an analysis regarding the cause and the measurement of the DLOM. The QMDM results are sensitive to the model inputs. In addition, the model inputs used in the QMDM and the Tabak model require the application of the analyst's judgment

Consideration of Ownership-Interest-Specific Transferability Restrictions

The restricted stock studies presented in this discussion present a multitude of factors that affect the DLOM for privately owned companies. Certain factors that affect the DLOM appear frequently.

For example, many of the restricted stock studies indicate that company size, block size, and dividends affect the DLOM.

There are other factors that affect privately owned companies that are not measurable in the restricted stock studies. These factors include contractual restrictions, such as a shareholder agreement, right of first refusal, buy-sell agreement, and the like.

Contractual restrictions can severely limit the marketability of a noncontrolling ownership interest in a privately owned company.

The following list presents some of the contractual restrictions that may affect the DLOM:

1. Buy-sell agreements
2. Shareholder or partnership agreements
3. Rights of first refusal
4. Other contractual transferability restrictions

The more restrictive the agreement or provision, the greater the appropriate DLOM, all else equal.

Other Factors Commonly Affecting the DLOM Measurement

A security is not either marketable or nonmarketable. Rather, there are varying degrees of marketability. The studies discussed above describe a starting point to estimate the DLOM. However, the facts and circumstances of each analysis determine the appropriate DLOM.

It is a matter of analyst judgment to select a DLOM based on:

1. the empirical DLOM evidence,
2. the theoretical DLOM evidence, and
3. the facts and circumstances of each analysis.

The following discussion considers the subject-specific factors that affect the DLOM.

In *Mandelbaum v. Commissioner*,[35] Judge David Laro cited nine specific (but nonexclusive) factors for analysts to consider in developing a DLOM:

1. Financial statement analysis
2. Dividend history and policy
3. Nature of the company, its history, its position in the industry, and its economic outlook
4. The company management
5. The amount of control in the transferred shares
6. The restrictions on transferability
7. The holding period for the stock
8. Subject company's redemption policy
9. Costs associated with a public offering

The *Mandelbaum* decision is cited frequently in decisions related to the measurement of the DLOM. The *Mandelbaum* factors are intuitive, and they reconcile with the empirical studies discussed above.

Analyses of the *Mandelbaum* factors, the empirical studies, the theoretical studies, and other DLOM literature make it clear that many company-specific and security-specific factors affect the magnitude of the DLOM.

These factors generally fall into three categories:

1. Dividend payments
2. Expected holding period
3. Subject company risk

The following discussion summarizes these three categories of DLOM factors.

Dividend Payments

The text *Valuing a Business*[36] explains the importance of dividends:

> Stocks with no or low dividends suffer more from lack of marketability than stocks with high dividends. Besides being empirically demonstratable, this makes common sense. If the stock pays no dividend, the holder is dependent *entirely* on some future ability to sell the stock to realize any return. The higher the dividend, the greater the return the holder realizes without regard for sale of the stock.

An investor in a closely held company would generally prefer some dividends to no dividends. When the subject is a noncontrolling ownership interest, the analyst should also consider that the future dividends may not equal the historical dividends.

Let's assume a closely held company makes an annual dividend payment equal to 100 percent of its annual cash flow. And, let's assume that all company shareholders are related. Under the fair market value standard of value, the willing buyer of a noncontrolling interest in this company will not be a family member.

In order for the economic benefits to remain within the controlling family, the company may:

1. discontinue paying dividends and
2. allocate the cash previously used for dividends to family members.

In this example, the presence of historical dividends is not the only factor to consider when analyzing dividends relative to a private company. The expected future dividends of the company may be considered in the DLOM measurement.

Expected Investment Holding Period

The second factor that affects the DLOM is the expected holding period. Both the *Mandelbaum* decision and Revenue Ruling 77-287[37] state that the expected holding period affects the DLOM. The restricted stock studies, the pre-IPO studies, the OPM studies, and the DCF models all consider holding period as a factor.

This holding period factor is associated with the DLOM for the following reasons:

1. It is clearly measured in empirical studies.
2. It is intuitive.
3. It encompasses a variety of other factors.

In Exhibit 6, the size of the DLOM is related to the expected holding period. As the holding period increases, so does the DLOM.

Closely Held Company Risk

The third factor that affects the DLOM is the subject closely held company risk. The restricted stock studies and the OPM studies conclude that the size of the DLOM is related to the stock price volatility (one measure for risk). The studies also associate company size (another measure for risk) with the DLOM size.

For example, the McConaughy, Cary, and Chen restricted stock study indicates, "There are three factors that remain significant: size, stability of revenue growth, and stock price volatility. These three factors clearly reflect the riskiness of investing in a company."[38]

Each of these three factors relates to the subject closely held company risk.

A large company is a "safer" investment than a similar small company, all other factors being equal. This conclusion is illustrated by comparing the expected rates of return on large-capitalization companies to small-capitalization companies. Ibbotson Associates makes this comparison:

> One of the most remarkable discoveries of modern finance is the finding of a relationship between company size and return. . . . The relationship between company size and return cuts across the entire size spectrum. . . . Small-cap stocks are still considered riskier investments than large-cap stocks. Investors require an additional reward, in the form of additional return, to take on the added risk of an investment in small-cap stocks.[39]

Exhibit 6
Emory Studies for 1980 to 2000 (after a 2002 Revision)
Price Discounts versus Time between Transaction and IPO

Number of Days	Price Discount Average	Price Discount Median	Transaction Count
0–30	30%	25%	18
31–60	40%	38%	72
61–90	42%	43%	162
91–120	49%	50%	161
121–153	55%	54%	130
Total			543

Source: Institute of Business Appraisers Annual National Conference, June 2, 2003.

Large closely held companies are perceived as safer investments than are small closely held companies. Larger earnings typically enable a closely held company to:

1. withstand downturns in the economy and subject industry and
2. capitalize on growth opportunities.

Factors in addition to size can also affect the subject company risk. The following list includes some of the common factors that may affect the subject closely held company risk:

- Historical financial ratios
- Historical earnings trends/volatility
- Management depth
- Product line diversification
- Geographic diversification
- Market share
- Supplier dependence
- Customer dependence
- Deferred expenditures
- Lack of access to capital markets

Summary and Conclusion

The DLOM Adjustment

Analysts are often asked to value noncontrolling, nonmarketable ownership interests in closely held companies. These valuations may be performed for gift tax, estate tax, generation-skipping transfer tax, income tax, property tax, and other taxation purposes.

Depending on the valuation approaches and methods applied and on the benchmark empirical data used, the analyses may initially conclude the valuation of a noncontrolling, marketable ownership interest. In such initial value instances, analysts often have to apply a valuation adjustment in order to reach the final (i.e., correct level of value) value conclusion.

This discussion summarizes the various factors that analysts typically consider in the measurement of a discount for lack of marketability (DLOM) associated with a noncontrolling, nonmarketable closely held business ownership interest.

The Application of the DLOM in the Valuation

In measuring the DLOM, analysts may consider all of the facts and circumstances relevant to the subject business ownership interest.

Based on the facts of a specific analysis, there are times when one study is more relevant than another. This is because marketability and lack of marketability are relative (and not absolute) terms.

The restricted stock studies conducted prior to 1990 indicated a DLOM of around 35 percent. After 1990, the DLOM indicated in the restricted stock studies decreased to around 25 percent. The average DLOM indicated in the pre-IPO studies was approximately 45 percent to 50 percent.

The different degrees of marketability in the ownership interests that supply the data points used in the various DLOM studies is a reason for the different DLOM indications.

If the subject closely held company or ownership interest has an expected holding period of one year or less, it may be appropriate to place more emphasis on the DLOM results from the post-1990 restricted stock studies than the pre-IPO studies.

If a liquidity event for the subject closely held company or ownership interest is not expected to occur for many years, then the results from pre-IPO DLOM studies may be more meaningful.

In addition to comparing the subject business ownership interest to the published DLOM studies, the subject ownership interest may require an upward or downward adjustment relative to the selected benchmark.

Some closely held company-specific and ownership-interest-specific factors include the following:

1. Historical and expected dividend payments
2. The expected holding period
3. Subject closely held company risk

Notes:

1. John Downs and Jordan Elliot Goodman, eds., *Barron's Dictionary of Finance and Investment Terms*, 6th ed. (Hauppauge, NY: Barron's, 2003), 406.
2. 17 CFR 230.144 (revised April 1, 1990).
3. SEC website: http://www.sec.gov/investor/pubs/rule144.htm
4. On February 18, 1997, the SEC adopted amendments to reduce the holding period requirements under Rule 144 of the Securities Act from two years to one year for the resale of limited amounts of restricted securities (the amendment became effective April 29, 1997). Further, on November 15, 2007, the SEC adopted similar amendments which reduced the holding period requirements from one year to six months (effective February 15, 2008).
5. See, for example, Bruce Johnson, "Restricted Stock Discounts, 1991–95," *Shannon Pratt's Business Valuation Update* (March 1999); Rod Burkert, "Cure for Declining Discounts, Deconstruct the Studies," *Trusts & Estates* (March 2004); and Robert Reilly, "Willamette Management Associates' Discount for Lack of Marketability Study for Marital Dissolution Valuations," *American Journal of Family Law* (Spring 2005).
6. 17 CFR Parts 230 and 239, December 17, 2007.
7. John A. Menicucci Jr., "SEC Adopts Amendments to Rule 144 & Rule 145," *The Nebraska Lawyer* (April 2008).
8. Emory was formerly with Robert W. Baird & Co. where the studies prior to April 1997 were conducted.
9. John D. Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock—January 1980 through June 1981," *Business Valuation News* (September 1985): 21–24, also in *ASA Valuation* (June 1986): 62–66; "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock, January 1985 through June 1986," *Business Valuation Review* (December 1986): 12–15; "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock (August 1987–January 1989)," *Business Valuation Review* (June 1989): 55–57; "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock, February 1989–July 1990," *Business Valuation Review* (December 1990): 114–16; "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock, August 1990 through January 1992," *Business Valuation Review* (December 1992): 208–212; "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock, February 1992 through July 1993," *Business Valuation Review* (March 1994): 3–5; "The Value of Marketability as Illustrated in Initial Public Offerings of Common

Stock, January 1994 through June 1995," *Business Valuation Review* (December 1995): 155–160; "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock, November 1995 through April 1997," *Business Valuation Review* (September 1997): 123–131; John D. Emory Sr., F.R. Dengel III, and John D. Emory Jr., "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock, May 1997 through December 2000, *Business Valuation Review* (September 2001): 15–19; and "Underlying Data in Excel Spreadsheet for 1980-2000 Pre-IPO Discount Studies, as Adjusted October 10, 2002," located at http://www.emorybizval.com/valuation-studies.shtml.

10. See John D. Emory Sr., F.R. Dengel III, and John D. Emory Jr., "Discounts for Lack of Marketability: Emory Pre-IPO Discount Studies 1980–2000, as Adjusted October 10, 2002," www.emoryco.com/valuation-studies.shtml.
11. The database is available on a subscription basis from www.bvmarketdata.com.
12. The specific analytical procedures performed in the various WMA pre-IPO DLOM studies are detailed in Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th ed. (New York: McGraw-Hill, 2000), 408–411.
13. European options have a single exercise date. In contrast, the holder of an American option can exercise the option at any time during the existence of the option.
14. David B.H. Chaffe III, "Option Pricing as a Proxy for Discount for Lack of Marketability in Private Company Valuations," *Business Valuation Review* (December 1993): 182–6.
15. Ibid.: 184.
16. Francis A. Longstaff. "How Much Can Marketability Affect Security Values?" *The Journal of Finance* (December 1995): 1767–74.
17. A "lookback" option differs from most other options in that the holder can look back at the end of the option's life and retroactively exercise the option at either the lowest stock price (for a call option) during the holding period or the highest stock price (for a put option) during the holding period.
18. Longstaff, "How Much Can Marketability Affect Security Values?": 1771.
19. Ashok Abbott, "Discounts for Lack of Liquidity: Understanding and Interpreting Option Models," *Business Valuation Review* 28, no. 3 (Fall 2009): 145.
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21. John D. Finnerty, "The Impact of Transfer Restrictions on Stock Prices," *Analysis Group/Economics* (October 2002).
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23. Ibid: 30
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25. Robert M. Seaman, "Latest LEAPS Study Sheds Light on Company Size and DLOMs," *Business Valuation Update* 19, no. 9 (September 2013).
26. Companies examined included Amazon, Ford Motor, General Motors, Morgan Stanley, Microsoft, Nextel, Qlogic, Qualcom, and Tyco.
27. Trout, "Minimum Marketability Discounts": 124–5.
28. Seaman, "Minimum Marketability Discounts—5th Edition," March 2010.
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30. Z. Christopher Mercer and Travis W. Harms, "Marketability Discount Analysis at a Fork in the Road," *Business Valuation Review* (December 2001): 23.
31. Z. Christopher Mercer, *Quantifying Marketability Discounts* (Memphis: Peabody Publishing, 1997).
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34. David Tabak, "A CAPM-Based Approach to Calculating Illiquidity Discounts," NERA Economic Consulting publication (November 11, 2002), www.nera.com.
35. Mandelbaum v. Commissioner, T.C. Memo 1995-255 (June 13, 1995).
36. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th edition, (New York: McGraw-Hill, 2008), 495.
37. According to Rev. Rul. 77-287, Section 6.02, "the longer the buyer of the shares must wait to liquidate the shares, the greater the discount."
38. Daniel L. McConaughy, David Cary, and Chao Chen, "Factors Affecting Discounts on Restricted Stock," *Valuation Strategies* (November/December 2000): 46.
39. *Ibbotson SBBI 2015 Classic Yearbook* (Chicago: Morningstar, 2015), 99, 113.

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Nate gratefully acknowledges the efforts of all of the other Willamette Management Associates analysts and researchers who contributed to the accumulation (over a number of years) of this collective research.

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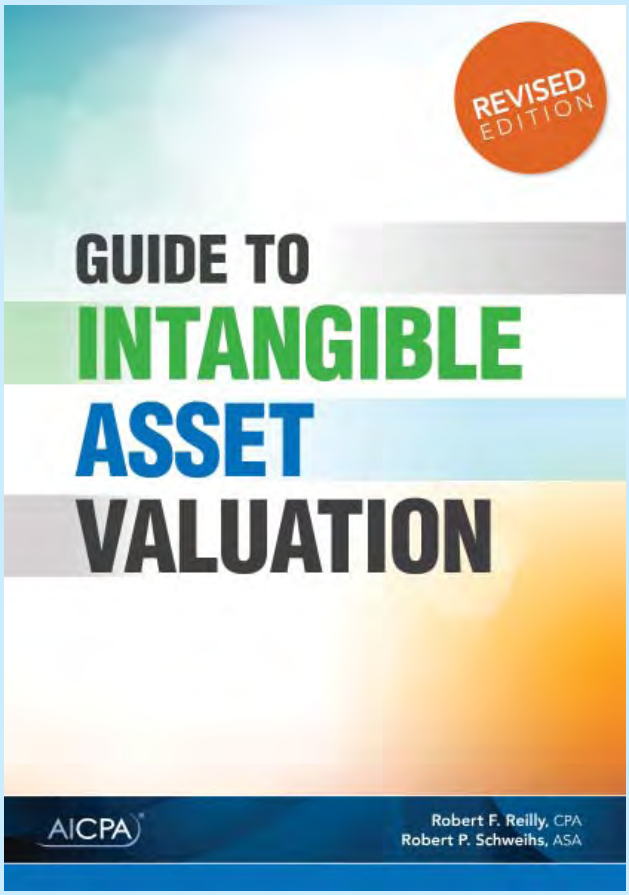
Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



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Guide to Intangible Asset Valuation

Table of Contents

Distinguishing Personal Goodwill from Entity Goodwill in the Valuation of a Closely Held Corporation

Robert F. Reilly, CPA

The valuation of a closely held corporation often has gift tax, estate tax, and generation-skipping transfer tax implications. In addition, the valuation of a closely held corporation often has income tax implications. In these tax-related instances, it is often important for the business owners (and for their professional advisers) to allocate the total enterprise value (or the total transaction consideration) between (1) the company-owned entity goodwill and (2) the individual shareholder/employee-owned personal goodwill. This discussion summarizes the valuation analyst considerations with regard to the elements of, the separability of, and the documentation of a shareholder/employee's personal goodwill.

Introduction

This discussion focuses primarily on the valuation of the closely held (or family-owned) company. Primarily, but not exclusively, this discussion focuses on the valuation of a closely held C corporation that is managed by its shareholder/employees.

In particular, this discussion focuses on the question of how much of the total business enterprise value relates to the personal goodwill of the company shareholder/employees.

There are numerous gift tax, estate tax, generation-skipping transfer tax, and income tax reasons why valuation analysts may be asked to allocate the subject business enterprise total intangible asset value between (1) the company's entity goodwill and (2) the individual shareholder/employee's personal goodwill.

This discussion is informed by the recent U.S. Tax Court decision in *Bross Trucking, Inc., et al. v. Commissioner of Internal Revenue*[1] (the "*Bross Trucking* decision").

There are several instances when it is important for a closely held corporation (and for its owners) to distinguish between:

1. the personal goodwill (owned by the individual shareholder/employees) and
2. the entity goodwill (owned by the company itself).

The first instance typically relates to the formation of the closely held company. In many closely held corporation formations, individual shareholder/employees transfer their personal goodwill to the newly formed corporation in exchange for newly issued shares of the corporation stock.

Those transfers of personal goodwill may qualify as a tax-deferred exchange (of personal goodwill for corporation stock) under Internal Revenue Code Section 351.

The alternative tax treatment (when personal goodwill is not transferred) is to treat the issuance of the corporation stock as taxable equity-based compensation for the shareholder/employee's "sweat equity" in the newly formed company.

The second instance may involve the conversion of the closely held C corporation to a closely held S corporation. In such a tax status conversion

transaction, the C corporation assets are valued on the date of the tax status conversion.

If the S corporation is then sold during the term of the Section 1374 built-in gain recognition period, that corporation would have to pay tax on any gain (i.e., the amount of the sale price over the tax basis of the company assets).

However, any assets that are owned outside of the C corporation (such as the shareholder/employee's personal goodwill) would not be part of the corporation's tax status conversion.

Therefore, the amount of any personal goodwill that would be transferred along with the sale of the (now) S corporation would not be subject to the Section 1374 built-in gain recognition. Of course, the individual shareholder/employee would still recognize one level of tax on the sale of his or her personal goodwill.

The third instance is the most common instance, and it relates to the sale (structured as an asset sale) of the closely held corporation. In such a sale, the business sale transaction would be structured as (and the deal documents should reflect) two separate transfers:

1. The sale of the closely held corporation assets
2. The sale of the shareholder/employee's personal goodwill

The sale of the assets of the C corporation will likely be subject to two levels of taxation: (1) once at the corporation level for the sale of any appreciated (sale price in excess of tax basis) assets and (2) again at the shareholder level related to the distribution of the after-corporate-tax sale proceeds to the individual shareholders.

However, the shareholder's sale of any personal goodwill should be subject to only one level of taxation. This is because the individual shareholder is selling his or her personal goodwill directly to the business acquirer.

In addition, any gain on the sale of the shareholder/employee's personal goodwill would typically be considered a capital gain, subject to preferential capital gains tax treatment. The capital gain treatment assumes that the personal goodwill was owned by the individual shareholder/employee for more than 12 months.

The fourth instance relates to other transfers of the closely held corporation stock or of the personal goodwill.

Such transfers could occur in a gift tax, estate tax, or generation-skipping transfer tax situation. Such situations depend on:

1. which assets (personal goodwill, entity goodwill, or other assets) were transferred,
2. who transferred and who received the transferred assets, and
3. the valuation of the transferred assets.

The *Bross Trucking* decision relates to such a set of circumstances. The Internal Revenue Service (the "Service") claimed that the owner of Bross Trucking Company, Inc. ("Bross Trucking") made a gift of transferred goodwill to a new company formed by his three sons.

Based on the Tax Court's judicial guidance provided in the *Bross Trucking* decision, this discussion considers:

1. the elements that demonstrate the existence of an individual shareholder/employee's personal goodwill,
2. the factors that differentiate the existence (and transfer) of personal goodwill from the existence (and transfer) of entity goodwill, and
3. the components of the transaction (and of the deal documentation) that indicate the transfer of personal goodwill as part of the overall closely held business sale transaction.

The *Bross Trucking* Decision

In the *Bross Trucking* decision, the Tax Court concluded that a trucking company owned by Chester Bross ("Chester") did not distribute goodwill to Chester who, in turn, did not transfer the goodwill to a newly formed trucking company owned by Chester's three sons.

The name of the sons' trucking company was LWK Trucking Co., Inc. (LWK).

Therefore, the Tax Court determined that Chester owed no gift tax with regard to any transfers to LWK or to his three sons.

In the *Bross Trucking* decision, Chester owned a road construction company. Chester also organized several other companies to provide services and equipment to his construction company. Chester was knowledgeable about the construction industry, and he had developed important relationships with government entities and other customers.

Chester created Bross Trucking, a wholly owned company, to haul construction-related materials and equipment for road construction projects. It is important to note that Chester did not have an

employment contract with—and he never signed a noncompete agreement with—Bross Trucking.

About 90 to 95 percent of the Bross Trucking primary customers were companies owned by Bross family members. However, Bross Trucking did not have any formal written service agreements with any of its customers.

After facing a series of audits and investigations, Bross Trucking received an unsatisfactory safety rating. Bross Trucking had experienced extensive investigations from both:

1. the United States Department of Transportation and
2. the Missouri Division of Motor Carrier and Railroad Safety.

Bross Trucking was in jeopardy because of heightened scrutiny from both federal and state safety inspectors. The company faced the possibility of having its hauling authority revoked.

In response to this negative attention and a possible company shutdown, Bross Trucking ceased its ongoing business operations. Nonetheless, Bross Trucking remained as a legal entity to address any potential regulatory claims and obligations.

To ensure continued trucking services to the Bross family businesses, Chester's three sons created LWK. Chester did not own any interest in LWK. And, Chester was not involved in managing LWK.

No assets were transferred from Bross Trucking to LWK. LWK met all regulatory requirements on its own. However, about 50 percent of the LWK employees previously worked for Bross Trucking.

LWK leased its equipment (primarily its trucks) from the same family-owned leasing business as Bross Trucking had. While LWK operated under a similar business model as Bross Trucking, it expanded into several other service lines.

Initially, some of the LWK trucks still displayed the Bross Trucking logos. However, these Bross Trucking logos attracted heightened scrutiny from the safety inspectors that had investigated Bross Trucking. Therefore, LWK used magnetic signs to cover up the Bross Trucking logos until it could afford to have the trucks repainted.

Chester and his wife did not report any gifts for the year in which LWK began operations. The Service issued a notice of deficiency to Mr. and Mrs. Bross, determining:

1. a distribution of corporate intangible assets to Chester and
2. a subsequent transfer of these intangible assets to the Bross sons.

The Service's notice of deficiency described the allegedly transferred intangible assets as the following intangible "attributes":

1. Goodwill
2. Established revenue stream
3. Developed customer base
4. Transparency of the continuing operations between entities
5. Established workforce including independent contractors
6. Continuing supplier relationships

The Service's notice of deficiency was unclear as to (1) whether each intangible "attribute" was supposed to be a separate intangible asset or (2) whether the "attributes" were supposed to be aggregated into goodwill as a whole.

The principal issues presented before the Tax Court in this matter were whether:

1. any appreciated intangible assets were distributed by Bross Trucking to Chester and
2. Chester made a gift of these distributed intangible assets to his sons.

The Tax Court initially determined that the intangible asset that was being transferred was goodwill. Goodwill is often defined as the expectation of continued patronage. The competitive advantage that constitutes goodwill may be represented by a number of property rights or legal interests.

Accordingly, the Tax Court concluded that the intangible "attributes" listed in the notice of deficiency were separate interests or legal rights that the Service alleged to have made up the Bross Trucking goodwill.

After reaching this initial conclusion, the Tax Court concluded that there was no corporate distribution of goodwill from Bross Trucking to Chester.

The Tax Court reached this conclusion because it determined that a business can only distribute corporate assets, not assets that it does not own. Specifically, a corporation cannot distribute intangible assets owned individually by its shareholders—in this case, Chester.

The Tax Court cited three reasons for this determination.

First, the Bross Trucking goodwill was limited to a workforce in place. At the time, Bross Trucking had lost most of its goodwill and reputation with its customers because of:

1. its unsatisfactory safety rating,

2. the heightened regulatory scrutiny from safety inspectors, and
3. the possibility of a shutdown of business operations.

The Tax Court classified these three circumstances as "the antithesis of goodwill." This antithesis of goodwill was demonstrated by the LWK need to hide the Bross Trucking name and logo on the LWK trucks.

At the time of the alleged transfer of goodwill, Bross Trucking could not expect any continued patronage. This was because its customers did not trust it and did not want to continue doing business with it.

The Tax Court recognized that Bross Trucking employed several mechanics and administrative staff. Bross Trucking may have used this assembled workforce in the corporation and transferred that assembled workforce to Chester.

However, the Tax Court indicated that the record was unclear as to whether its independent contractor drivers could be counted as part of the Bross Trucking assembled workforce.

Second, nearly all the goodwill used by Bross Trucking was part of Chester's personal assets. The Bross Trucking established revenue stream, its developed customer base, and the "transparency of the continuing operations" were all a result of Chester's work in the road construction industry and the personal relationships that he had developed.

The Tax Court concluded that a company does not have any entity goodwill when all of the goodwill is attributable solely to an individual shareholder/employee's personal ability.

Third, Chester did not transfer his personal goodwill to Bross Trucking partly because he did not have an employment contract or a noncompete agreement with the company. The Tax Court noted that an employer has not received personal goodwill from an employee where that employer does not have a right to the employee's future services.

Therefore, Chester's personal goodwill remained a personal asset, separate from the Bross Trucking corporate assets.

The Tax Court concluded that because Chester did not gift the intangible assets to his three sons, he was not required to file a gift tax return. Because Bross Trucking did not distribute intangible assets to Chester, the Tax Court determined that any remaining issues were moot.

The Tax Court also determined that Bross Trucking did not transfer intangible assets. This is because the intangible assets that the Service alleged to be transferred, Bross Trucking never owned. Rather, these intangible assets were personally owned by Chester.

The Elements of the Personal Goodwill

"The primary requirement related to personal goodwill is for the business owner to establish that his or her personal goodwill exists separate from any closely held corporation's entity goodwill."

The primary requirement related to personal goodwill is for the business owner to establish that his or her personal goodwill exists separate from any closely held corporation's entity goodwill. Personal goodwill is property with a value dependent solely on the personal characteristics of the individual business owner.

Although very fact specific, these personal characteristics can include the personal relationships, ability, personality, and reputation of the individual shareholder where the company does not have a right by contract or otherwise to that individual's future services.

Judicial guidance with regard to this particular element of personal goodwill is provided in several Tax Court decisions, including *Martin Ice Cream Co.*,[2] *Norwalk*,[3] and *Schilbach*.[4]

In the *Bross Trucking* decision, Chester, a successful construction businessman, had established close, personal relationships with his primary customers. Additionally, Chester was extremely knowledgeable about the trucking industry because of his many years of experience. To that end, customers sought these personal traits through their relationships with Chester, which led directly to business for Bross Trucking.

As a result, the Tax Court concluded that Chester's personal goodwill existed through these relationships.

The Tax Court noted that the facts in the *Bross Trucking* case were analogous to the facts in the *Martin Ice Cream* case. In the *Martin Ice Cream* decision, the corporation's success was attributed to the individual shareholder's personal relationships with his retail customers. These personal relationships constituted an intangible asset used to establish a revenue stream and to develop a customer base.

However, because these personal relationships—and the corresponding intangible assets—were

never transferred to the corporation, the Tax Court held that the intangible assets were the shareholder's personal property.

Similarly, the Tax Court in the *Bross Trucking* decision held that any existing goodwill from Chester's personal relationships was his personal goodwill.

One factor in the *Bross Trucking* decision supporting the position that it was Chester's personal goodwill was that Bross Trucking clearly lacked its own entity goodwill. Bross Trucking had an impending suspension from various regulatory infractions, causing it to face bankruptcy. Further, the impending suspension caused customer uncertainty and business interruptions that impaired the business.

Unlike many situations involving claims of personal goodwill, the nonexistence of entity goodwill was clear in the *Bross Trucking* decision.

In addition, the Tax Court distinguished the *Bross Trucking* decision from the *Solomon* decision.[5] In *Solomon*, the corporation's success occurred because of the company's products and not because of any relationships that the shareholders formed.

In the *Solomon* decision, the taxpayers failed to convince the Tax Court that their personal abilities in developing an iron ore processing business were of any value.

The Tax Court concluded that the acquiring party

> did not need the goodwill of Solomon Colors or any of its key employees to succeed; in fact, after the acquisition [the acquiring party] continued to do business under its own name, not under the name of Solomon Colors.

Also, in the *Solomon* decision, the selling shareholders effectively ended their involvement in the business following the company sale, further indicating that their personal abilities were dispensable.

The Separability of the Personal Goodwill

A second requirement for the existence of personal goodwill is that the individual shareholder possess the right to sell his or her goodwill. To avoid corporate-level income tax, the personal goodwill must be the shareholder's individual asset. And, the shareholder cannot have previously transferred that personal goodwill to the corporation.

Tax Court precedent establishes that personal goodwill is transferred to a corporation when the individual shareholder/employee cannot personally benefit from it without the employer corporation. This issue is discussed in such Tax Court decisions as *Martin Ice Cream Co.*[6] *Norwalk*,[7] *H&M, Inc.*,[8] and *Bross Trucking, Inc.*[9]

Personal goodwill is often transferred through shareholder or employment agreements, such as an employment contract or a noncompete agreement. In general, once such an agreement is in existence, any current goodwill (or goodwill created thereafter) will likely belong to the corporation.

In the *Bross Trucking* decision, Chester never entered into an employment contract or a noncompete agreement with the company. Chester was free to leave the company and take his relationships with him if he decided to compete against the business.

The Tax Court stated "[a]n employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee."

As a result, the lack of such agreements allowed the Tax Court to conclude that Chester did not transfer his personal goodwill to the corporate entity.

The favorable facts in the *Bross Trucking* decision may be contrasted with the facts in *Howard*.[10] In that Appeals Court decision, Larry Howard, a practicing dentist, incorporated his sole proprietorship and entered into an employment agreement and a noncompetition agreement with the corporation. Later, Larry decided to sell his practice.

Larry argued that the sale included the sale of his personal goodwill. The Service, however, recharacterized the payment that Larry received. Larry claimed the payment to be for the sale of personal goodwill. The Service classified the payment as a dividend payment from the corporation.

The Ninth Circuit concluded that Larry's personal goodwill did not exist separately from the corporate assets. Specifically, the Appeals Court noted that, although Larry possessed some personal goodwill through his patient relationships, "the economic value of those relationships did not belong to him, because he had conveyed control of them to [his business]."

As a result, the Ninth Circuit upheld the Service's recharacterization of the transaction payment as a dividend.

The Documentation of the Personal Goodwill

While not an issue in the *Bross Trucking* decision, it is noteworthy that certain formalities and documentation will help support the taxpayer positions taken with respect to personal goodwill. Personal goodwill should be:

1. valued by an independent valuation analyst,
2. clearly identifiable in the purchase agreements, and
3. agreed to by the acquiring party.

In the *Kennedy* decision,[11] James Kennedy, the sole shareholder of KCG International, sold his consulting business corporation. Late in the negotiation process, the transaction parties agreed that:

1. 25 percent of the purchase price should be designated as a payment for consulting services and
2. the remaining 75 percent should be designated as a payment for James' personal goodwill.

To effectuate the sale of James' personal goodwill, the parties entered into three separate agreements, one of which was for the sale of James' personal goodwill and customer lists. In a separate agreement, James agreed to continue to service his former clients as an employee of the acquirer.

While the Tax Court found that James did own personal goodwill, it held that the identification of personal goodwill is not enough to conclude that the personal goodwill had been sold. The Tax Court stated that "[e]ven though a payment to a service provider can be considered a payment for goodwill in certain circumstances, we are convinced that the payments to Kennedy were consideration for services rather than goodwill."

The Tax Court went on to state that it found

> it significant that there is a lack of economic reality to the contractual allocation of the payments to goodwill. In other cases, the contractual allocation of a portion of a payment to goodwill has been important in determining that the payment was indeed for goodwill. In those other cases, the contractual allocation appeared to genuinely reflect the relative value of the seller's customer relationships compared to the value of the seller's ongoing personal services.[12]

The Tax Court's decision was based on the lack of an independent valuation or any other meaningful attempt to allocate the transaction sales proceeds. Accordingly, the *Kennedy* decision illustrates the importance of formal documentation regarding the value of personal goodwill—with an independent valuation to support the contractual sale price allocation.

The Tax Court also looked to the actual language of the purchase agreements in the *Solomon* decision. In the *Solomon* decision, the taxpayers (i.e., father and son shareholders) argued that the acquiring party purchased the shareholders' personal goodwill. The taxpayers argued that such personal goodwill represented value generated from their customer relationships.

In its decision, the Tax Court concluded three reasons why the taxpayers did not sell personal goodwill.

First, the Tax Court concluded that nothing in the transaction agreement between the parties referred to the sale of personal goodwill or customer lists personally owned by the taxpayers.

Second, unlike the facts in the *Martin Ice Cream* decision, the Tax Court concluded that the facts did not support that the value of the business was attributable to the taxpayers' personal attributes and relationships.

Third, although the taxpayers entered into noncompete agreements, the Tax Court concluded that the lack of employment or consulting agreements arguably demonstrated that the intent was not the purchase of personal goodwill.

As a result of these three factors, the Tax Court attributed the transaction payments to the taxpayers' covenants not to compete in the *Solomon* decision.

Summary and Conclusion

Based on the above-described judicial guidance, it is clear that the lack of supporting contractual documentation and the lack of an independent valuation may damage an otherwise strong case for the sale of personal goodwill.

In general, the sale of a C corporation through an asset sale structure will result in two levels of income tax:

1. A taxable gain to the corporation
2. A taxable distribution to the shareholders

One strategy for closely held corporation shareholders to avoid this double taxation involves the assertion that a portion of the business sale relates to

the sale of the personal goodwill of the shareholder/employee. Therefore, a portion of the total purchase consideration should only be taxed once—as a capital gain to the shareholder/employee directly.

The concept of personal goodwill is well-established, dating back to the above-mentioned Tax Court decision in *Martin Ice Cream Co*. The *Martin Ice Cream* decision involved a father and son who operated an ice cream distribution business through a corporation.

The Tax Court concluded that the success of the business depended entirely on the father, who had personal relationships with supermarket owners and an oral agreement with the founder of Häagen-Dazs to distribute a line of super-premium ice cream to supermarkets.

At no time did the father have an employment agreement with Martin Ice Cream. Following the purchase of Häagen-Dazs by Pillsbury, negotiations between Martin Ice Cream and Häagen-Dazs ensued for the acquisition of the Martin Ice Cream ice cream distribution business.

The father and son disagreed on the future of the business, and they decided to split the assets of the corporation in what was meant to be a tax-free split-off under Section 355.

The Tax Court concluded that the transaction failed the requirements of Section 355. Therefore, Martin Ice Cream was subject to tax on the distribution of appreciated property under Section 311.

In determining the income tax impact to Martin Ice Cream, the Tax Court analyzed whether the father had (1) transferred certain intangible assets to the corporation or (2) retained these intangible assets personally.

The Tax Court concluded that the success of the business depended entirely on:

1. the father's relationships in the marketplace and
2. the father's oral agreement with the founder of Häagen-Dazs.

The Tax Court concluded that these assets represented personal intangible assets.

The Tax Court concluded that these assets could not be owned by Martin Ice Cream. This was because the father never entered into a covenant not to compete or any other agreement with Martin Ice Cream that would result in the transfer of rights in those assets to Martin Ice Cream.

The recent Tax Court decision in *Bross Trucking* illustrates that, with the right set of facts, the sale of personal goodwill, as an asset separate from corporate-owned goodwill, should withstand a challenge from the Service.

For an individual shareholder/employee to sell his or her personal goodwill, that intangible asset must:

1. meet the definition of goodwill from a tax perspective and
2. be owned by the individual outside of the legal business entity.

The main issue in the *Bross Trucking* decision was the Service's contention that Bross Trucking distributed appreciated intangible assets (including goodwill) to its sole shareholder, Chester Bross.

The Service alleged that Chester then transferred those intangible assets to a newly created trucking entity that his three sons owned.

In holding for Chester, the Tax Court concluded the following:

1. Bross Trucking had no corporate goodwill at the time of the alleged distribution.
2. Chester's personal goodwill constituted all of the Bross Trucking goodwill.
3. Chester did not transfer any of this personal goodwill to the company that he had owned and operated.

Notes:

1. Bross Trucking, Inc. v. Commissioner, T.C. Memo 2014-107 (June 5, 2014).
2. Martin Ice Cream Company v. Commissioner, 110 T.C. 189 (1998).
3. Norwalk v. Commissioner, T.C. Memo 1998-279 (July 30, 1998).
4. Christhart S. and June Schilbach v. Commissioner, T.C. Memo 1991-556 (Nov. 6, 1991).
5. Solomon v. Commissioner, T.C. Memo 2008-102 (Apr. 16, 2008).
6. Martin Ice Cream Co., 110 T.C. 198.
7. Norwalk, T.C. Memo. 1998-279.
8. H&M, Inc. v. Commissioner, T.C. Memo 2012-290 (Oct. 15, 2012).
9. Bross Trucking, Inc., T.C. Memo 2014-107.
10. Howard v. U.S., 448 Fed.Appx. 752 (9th Cir. 2011).
11. Kennedy v. Commissioner, T.C. Memo 2010-206 (Sept. 22, 2010).
12. Id., at *23.

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Closely Held Business Goodwill Valuation Approaches and Methods

Robert F. Reilly, CPA

Valuation analysts are often called on to value closely held entity goodwill for various gift tax, estate tax, or generation-skipping transfer tax purposes. Analysts may also be asked to value the business entity goodwill for income tax or property tax purposes. These entity goodwill valuations may be performed for tax planning, tax compliance, or tax controversy purposes. This discussion summarizes the generally accepted approaches and methods that analysts typically consider in the valuation of business entity goodwill.

Introduction

There are numerous reasons why valuation analysts ("analysts") may be asked to value corporate (also called institutional) goodwill within a gift tax, estate tax, and generation-skipping transfer tax context. Analysts may also be asked to value a business entity's goodwill in an income tax and/or property tax context.

This discussion summarizes the generally accepted approaches and methods that analysts consider in the valuation of business entity goodwill.

Cost Approach Goodwill Valuation Methods

Using the cost approach, analysts estimate the amount of current cost required to recreate the closely held entity goodwill components. The cost approach typically involves a component restoration method.

The first procedure in this method is to list all of the individual components of the subject entity's goodwill. The second procedure is to estimate the current cost required to replace each component. This procedure is based on the concept of goodwill as the intangible value of all of the entity assets in place and ready to use.

One procedure in the restoration method is the analysis of forgone income (considered an "opportunity cost" in the cost approach) during the time period required to assemble all of the entity's tangible assets and identifiable intangible assets.

Let's consider the restoration method to value the goodwill of the Taxpayer Mining Company ("Taxpayer"). Let's assume that it would take two years to assemble all of the Taxpayer tangible assets and intangible assets.

The Taxpayer tangible assets include the following:

1. Land and buildings
2. Mining equipment, transportation equipment, and mining office equipment

The Taxpayer intangible assets include the following:

1. Operating licenses and permits
2. Computer software
3. Operating manuals and procedures
4. Customer relationships
5. Supplier relationships
6. A trained and assembled workforce

This two-year time period represents the total elapsed time required for the assembled assets to reach the same level of utility, functionality, capacity, and income generation as it currently exists in the actual business entity.

This hypothetical asset restoration process includes the following procedures:

1. The purchase and installation of all equipment
2. The construction or purchase of all real estate
3. The selection of suppliers
4. The creation of a distribution system
5. The hiring and training of employees
6. The building of a level of consumer recognition and confidence
7. The recreation of the current level of customer relationships

In this method, all of these tangible assets and intangible assets are assembled at the level required to accommodate the actual Taxpayer operations.

Illustrative Taxpayer Analysis

Let's assume that Taxpayer actually earns $10,000,000 per year in income (defined as net cash flow) during an expected two-year asset restoration period. The present value of the $20,000,000 forgone income during the restoration period is one component of opportunity cost.

Let's assume that Taxpayer would also incur $5 million of interest expense each year for the two-year restoration period. This expense occurs because Taxpayer will have to finance the purchase and assemblage of all of its assets (with no offsetting operating income).

During the restoration period, Taxpayer will not earn $10 million per year of positive cash flow (due to no business operations during the restoration), and Taxpayer will incur $5 million per year of negative cash flow (that is, interest expense on the restoration investments).

The present value of these two opportunity cost components would indicate the subject entity goodwill value.

Market Approach Goodwill Valuation Methods

There are two common goodwill market approach methods. The residual from purchase price method values goodwill as the residual from an actual acquisition price. The sales comparison method values goodwill based on an analysis of guideline sale transactions.

Goodwill is rarely sold separately from the other tangible or intangible assets of a business. Therefore, the guideline transactions usually involve the sale of a going concern business.

The analyst selects publicly reported transactions in which the allocation of the sale price between the purchased goodwill and all other acquired assets is reported. This market approach method effectively relies on a residual from purchase price procedure to value goodwill.

To use the residual from purchase price method, there has to be a sale of the subject entity.

First, if there is such a transaction, the analyst confirms that the transaction was at arm's length.

Second, the analyst confirms that the purchase price represents a cash equivalency price. If there are noncash consideration components or deferred payments (an earn-out provision) as part of the purchase price, the analyst converts the entire consideration to a cash equivalency price.

Third, the analyst values of each of the tangible assets and identifiable intangible assets.

Fourth, the analyst subtracts the total value of all of the tangible assets and identifiable intangible assets from the purchase price. The residual amount represents goodwill value.

To use the guideline sale transactions method, the analyst identifies and selects actual sales of guideline entities that are sufficiently similar to the subject entity. Comparability is typically based on the criteria of investment risk and expected return.

For certain types of businesses, guideline sale transactional data are fairly easy to assemble. Such transactional data are reported in publicly available publications and periodicals. The purchased goodwill is typically expressed as a percent of the total transaction price or a percent of the total annual revenue earned by the entity sold.

These market-derived goodwill pricing multiples are then applied to the subject entity to value the entity's value. It is noteworthy that the pricing multiples are estimated; that is, these transactional pricing multiples are themselves based on an allocation of the purchase price for each business included in that transactional data source.

Illustrative Closely Held Analysis

Let's assume that Closely Held Construction Consolidated (CHCC) is negotiating to sell its structural steel division. The parties can agree to value the division equipment at $60 million. However, the parties cannot agree on the value of the division goodwill.

The buyer retains an analyst to value the division goodwill. The analyst decides to use the market approach. Researching various publications and

transactional databases, the analyst concluded that, over the last few years, the portion of goodwill in the purchase price of comparable structural steel contractor acquisitions was 40 percent.

Therefore, if the agreed tangible asset value is $60 million and the goodwill portion of the total purchase price is 40 percent, then the total division value is $100 million.

Based on that $100 million value, 60 percent would be allocated to the tangible assets and 40 percent would be allocated to goodwill. Accordingly, the parties agreed to a transaction sale price of $100 million.

Income Approach Methods

The income approach goodwill valuation methods include the residual from business value method, the capitalized excess earnings method, and the present value of future income method.

Each of these methods is based on the concept of goodwill as the present value of future income not associated with the subject entity's tangible assets or identifiable intangible assets.

The Residual from Business Value Method

The residual from business value method is based on the principle that the value of total assets (the "left hand" side of the subject entity's balance sheet) equals the value of total liabilities and equity (the "right hand" side of the subject entity's balance sheet).

Goodwill is valued as the total entity value less:

1. the value of all working capital (or financial) assets,
2. the value of tangible assets (real estate and tangible personal property), and
3. the value of identifiable intangible assets.

The analyst typically synthesizes the value indications of one or more of the generally accepted business valuation methods to estimate the entity value.

The business valuation methods commonly used in the residual from business value method include the following:

1. The direct capitalization method (an income approach method)
2. The discounted cash flow or yield capitalization method (an income approach method)
3. The guideline merged and acquired company method (a market approach method)
4. The guideline publicly traded company method (a market approach method)

Any of these methods may be used in a residual from business value analysis. The discounted cash flow method is a common business valuation method for the purpose of quantifying entity goodwill as the residual from a business value.

The discounted cash flow method is based on the principle that business value is the present value of the total future income to be derived by the subject entity's stakeholders. The discounted cash flow method typically involves revenue analysis, expense analysis, investment analysis, cost of capital analysis, and residual value analysis.

Based on these valuation analyses, the periodic (typically annual) cash flow from the subject entity is projected for a discrete projection period. The term of the discrete period varies based on the analyst's judgment.

Typically, the term of the projection period approximately equals the average length of the industry business cycle. The discrete cash flow projection is discounted at an appropriate discount rate to determine a present value.

The residual value of the entity is estimated at the end of the discrete projection period. The residual value is also discounted to determine a present value. The present value of the discrete cash flow projection is summed with the present value of the residual value.

This summation calculation indicates the total entity value. The total entity value less the tangible assets value and the identifiable intangible assets value indicates the goodwill value.

Illustrative Family Analysis

Let's assume that Family Corporation ("Family") is considering the purchase of the Target Corporation ("Target") business assets. Family wants to estimate the income tax consequences of the acquisition, including the expected amortization of purchased goodwill. Family is considering a cash for assets structure with no assumed liabilities.

Family management concluded the total value of the Target operating assets to be $100 million. Family management anticipates the transaction purchase price allocation presented in Exhibit 1.

Family management expects that the proposed acquisition (at an assumed $100 million purchase

Exhibit 1
Target Corporation
Purchase Price Allocation

Assumed Total Consideration Paid		$100,000,000
Less:	Fair Market Value of the Target Assets Acquired:	
	Cash	5,000,000
	Accounts Receivable	5,000,000
	Inventory	5,000,000
	Land	5,000,000
	Buildings	20,000,000
	Equipment	30,000,000
	Patents and Technology	10,000,000
	Trademarks and Trade Names	10,000,000
	Subtotal	$90,000,000
Equals:	Fair Market Value of the Goodwill Acquired	$10,000,000

price) will result in $30 million of amortizable Section 197 intangible assets—including $10 million of amortizable goodwill.

The Capitalized Excess Earnings Method

The capitalized excess earnings method involves the quantification and capitalization of excess income (as defined) earned by the subject entity. There are several versions of the capitalized excess earnings method.

The following discussion presents a common application of this valuation method.

First, the capitalized excess earnings method requires an estimate of required amount of income that an investor would expect, given the risk of the subject entity. This procedure often involves the assessment of industry average rates of return.

Some analysts apply an asset-specific rate of return to each asset category. Some analysts apply the entity's cost of capital as the overall required rate of return. The cost of capital is typically measured as the weighted average cost of capital.

In either case, the required return on investment is multiplied by the value of the identified net assets in order to quantify the amount of the required income. The identified net assets typically include all of the working capital, tangible assets, and identifiable intangible assets.

Second, the analyst quantifies the difference between this required income amount and the actual income earned by the subject entity. If the actual income exceeds the required income, then excess earnings exist at the subject entity.

Third, the analyst capitalizes the excess earnings (if any) as an annuity in perpetuity using an appropriate direct capitalization rate. The derivation of the direct capitalization rate should be consistent with the level of income used to measure the subject entity's required income amount and the entity's actual income.

The result of the direct capitalization procedure indicates goodwill value.

Present Value of Future Income

The first procedure in this method is to identify all of the future income that is not associated with the subject entity's tangible assets and identifiable intangible assets. This identification procedure may include future capital expenditures, future mergers and acquisitions, new product or service lines, new sales territories, or new customers.

Generally, this future income is not included in the current business plans or forecasts. This future income is typically not associated with the tangible assets or intangible assets in place as of the analysis date. Otherwise, that future income would be included in the value of the entity's tangible assets or intangible assets. Creating such a projection of future income may present an analytical challenge.

For purposes of illustrating this method, let's limit the discussion to analyzing the present value of the expected future customers. In any residual method goodwill analysis, it is common for the analyst to estimate and present value the prospective income associated with the current customer base.

This income projection is typically made over the expected remaining useful life of the current customer relationships. The value of the current customer base is the present value of the income to be earned from providing future products or services to current customers.

Using the present value of future income method, goodwill is estimated as the present value of the future income to be earned from providing future goods or services to future, unidentified, customers. These future customers are unidentified new customers who (presumably) will take the place of the current customers as the current customers retire.

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Symposium—What Estate and Trust Counsel Say about the Current State of Estates and Trusts

Fady F. Bebawy

This Insights *symposium presents a series of questions and answers between our* Insights *issue editor and a panel of distinguished and seasoned estate and trust counsel from across the United States. These legal counsel practice in the area of estate planning, trust administration, and transactional matters. These legal counsel share their experience and expertise with regard to judicial developments in estate planning, estate administration, estate tax compliance, and estate tax controversies.*

Introduction

The practice of trusts and estates law is an area that is far reaching. The old adage says that the only two certainties in life are death and taxes. The legal discipline of estates and trusts deals directly with these two inevitabilities. Accordingly, trust and estate law may touch each one of us.

If trusts and estates counsel are the "conductors" of the metaphorical symphony of the estate plan, then valuation analysts play one of the important "instruments."

Figure 1, defined as the intergenerational wealth transfer management (IWTM) continuum, illustrates the "solo" parts where valuation analysts perform their role in the estate planning process.

That valuation analyst role is performed in the development of—and in the execution of—the estate plan.

That is, business and security valuations are often required when a high net worth individual transfers wealth to children or to others by way of:

1. a gift,
2. a generation-skipping transfer, or
3. an estate transfer.

Valuation analysts may also get involved in estate tax controversy matters when the estate transfer is challenged by the Internal Revenue Service (the "Service").

Since estate planning is an area that affects many of us, it should be helpful to our readers to learn from tax law experts with regard to the following issues:

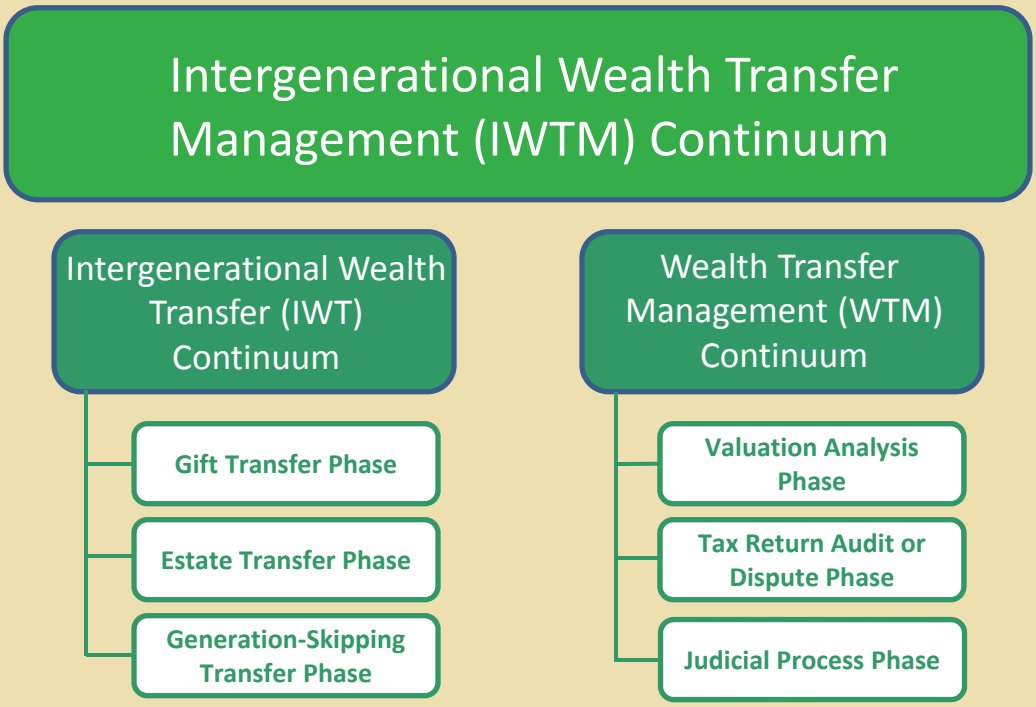
1. What services are included in their practice areas?
2. What is some of the salient case law that affects their practice?
3. When are valuations required?
4. What are the challenges?
5. What should we do?

Our symposium panel is comprised of Matthew S. Beard, a partner with Meadows, Collier, Reed, Cousins, Crouch & Underman, L.L.P., and Adam M. Damerow, an associate with McGuireWoods LLP.

Matthew Beard's practice spans two broad areas of taxation: (1) estate planning and (2) probate and income tax and business planning.

In his estate planning and probate practice, Mr. Beard designs and implements estate plans and business succession plans with an emphasis

Figure 1
Intergenerational Wealth Transfer Management Continuum



on federal tax issues. He often works closely with accountants, bankers, and other financial advisers during this planning process.

Mr. Beard also represents fiduciaries in all facets of estate and trust administration. This representation typically includes court proceedings, tax matters, administration and transfer of assets, and matters before the Service.

Mr. Beard is the author of *An Introductory Guide to Tax and Estate Planning*, which provides an introduction to estate planning under Texas law and planning for federal estate, gift, and generation-skipping transfer taxes.

With regard to transactional matters, Mr. Beard advises clients with a focus on tax issues. He works with a broad range of entities, such as partnerships, limited liability companies, and publicly traded C corporations. Common transactions include formations, acquisitions/mergers, and liquidations.

Mr. Beard is also the author of *Annotated Tax Provisions for Limited Liability Companies*, which includes tax provisions for company agreements with explanations of how the provisions operate and provide pass-through taxation.

Adam Damerow concentrates his practice on estate planning and administration for professionals, executives, closely held business owners, and other high net worth individuals.

His experience includes the preparation of various estate planning documents, ranging from wills, revocable trusts, and powers of attorney to work on generation-skipping transfer tax-exempt trusts, sales to grantor trusts, GRATs, and formation of family LLCs/partnerships.

Mr. Damerow also has experience practicing in Illinois probate court and in federal tax controversy work against the Service.

Mr. Damerow devotes a significant part of his practice to advising nonprofit entities, including private foundations and public charities, on compliance, administration, and funding issues at state and federal levels. He also regularly prepares corporate documents for family-owned businesses, including buy-sell agreements and business formation and operation documents.

Mr. Damerow also advises U.S. citizens living in the United Kingdom on multijurisdictional tax issues.

Symposium Discussion

Insights: Please describe your legal practice and your specific subject matter expertise.

Beard: I am a tax attorney and partner with Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P., in Dallas, Texas. I focus on estate planning and transactional matters, which typically involve partnerships and trusts.

Damerow: I am an estate planning attorney in the Private Wealth Services Group of McGuireWoods. Our typical clients are high net worth individuals who are often first generation, wealth-creating business owners and executives.

We assist our clients in all aspects of their estate planning, from establishing basic estate and business succession plans to designing and implementing wealth transfer strategies whose primary goal is to maintain the family's wealth for both the current and future generations.

We also represent fiduciaries in contested estate and trust administration matters.

Insights: Please identify and briefly describe any judicial precedent that you find most useful in the estate planning for—and the executing of—intergenerational wealth transfers.

Beard: I find it interesting to compare *Kimbell v. U.S.*[1] and *Strangi v. Commissioner.*[2] The decisions are examples of successful and unsuccessful implementation of an estate plan.

Although the facts share many similarities, the courts reached different results. In both cases, the taxpayer hired an attorney to prepare and implement a partnership as part of an estate plan, partnership formalities were followed during formation and funding, the partnership was formed shortly before the taxpayer's death, and a significant amount of cash and securities were transferred to the partnership.

The taxpayers lived in the same state, and the cases were considered by the same Court of Appeals during the same period of time. Nevertheless, the partnership in *Strangi* was disregarded for federal estate tax purposes, whereas the partnership in *Kimbell* was not. A few important facts led to this result.

In *Strangi*, the taxpayer contributed 98 percent of his wealth, including his residence, to the partnership, distributions were made thereafter for personal expenses, and the taxpayer continued to live in the residence.

In contrast, the taxpayer in *Kimbell* retained sufficient assets for anticipated living expenses, did not use partnership property for personal purposes, and the partnership held an operating oil and gas business.

These judicial decisions indicate that the proper implementation of an estate plan is critical to the success of that plan.

A person involved with the transfer of property to an irrevocable trust that is intended to be excluded from a taxpayer's estate should know of Revenue Ruling 95-58. In that ruling, the Service revoked its prior position with respect to a grantor's reservation of a power to remove a trustee and appoint a new trustee.

The Service's current position is that a grantor who possesses a power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the grantor (within the meaning of Section 672(c)) will not be treated as retaining the trustee's discretionary control over trust income.

Professional advisers involved with a transfer that requires the reporting on a tax return should be familiar with the limitations on assessment and collection contained in the regulations under Section 6501.

The Section 6501 regulations provide safe harbors for the adequate disclosure of a transfer on a return, whether the transfer is a gift or a nongift completed transfer. Importantly, the regulations include a safe harbor for the submission of an appraisal in lieu of certain financial data.

Damerow: We have recently resolved several transfer tax audits where the central issue was the appropriate marketability and control discounts applicable to the client's closely held business interests where the underlying company assets were marketable securities.

In several of these cases, the Service cited and relied on the *Estate of Curry v. United States,*[3] which extensively cites *Ahmanson Foundation v. United States.*[4]

In addition to the standard recitation of the willing buyer/willing seller test, the court in *Curry* says that if the taxpayer owns a controlling block of voting shares in a company, then the value of the taxpayer's nonvoting shares will be the same value as the taxpayer's voting shares (i.e., no additional discount for the nonvoting shares).

This is one of a number of reasons why we use our best efforts to convince our clients to relinquish voting control of the company as early as possible, which is often easier said than done.

However, even if a client dies with voting control of the company, there are certain protections afforded minority shareholders under state law and/or the controlling company documents (such as liquidation rights) which can help to provide a

"... the most common area of dispute in valuation cases we are seeing is the appropriate DLOM applicable to interests in closely held business entities."

valuation ceiling for a controlling shareholders' interest. *Curry* addresses these issues as well.

Therefore, we found that *Curry* and its progeny are a useful set of cases for both the Service advisers and the taxpayers advisers. This is because these cases help to define the landscape of valuation issues that need to be considered where a client retains voting control and which may arise during planning, implementation, tax reporting, and audit.

Insights: How often do the cases that require valuation services get challenged by the taxing authority? What trend have you seen, if any, in the past five years regarding the incidence of taxing authority challenges to valuations?

Beard: Two things are certain in life—death and taxes. Estate planning deals with both. The Service continues to be vigilant. I have seen fewer examinations for estates with less than $10 million, and more examinations for large estates.

When a closely held business is involved, the Service has recently focused on valuation issues rather than on application of Section 2036.

Damerow: Based on our recent observations and anecdotes, it appears that the rise in the applicable federal estate tax exemption, which necessarily reduced the number of taxable estates, has led to an increase in the number of estate tax returns receiving closer scrutiny by the Service. However, not all of this scrutiny led to adjustments.

The Service knows that if it takes a close look at a tax return that includes an asset with a valuation discount, there is an opportunity to extract additional transfer tax dollars from the taxpayer.

We have also seen situations where once the client's gift tax return is audited, so too are the family's later gift and estate tax returns (i.e., once a client is on the Service's radar, we assume every return will be audited and keep in mind the past audit experience when preparing future transfer tax returns).

The good news is, despite an increased number of our clients' returns being audited by the Service in recent years, in cases where an adjustment is made, the taxpayer still secured significant valuation discounts.

More importantly, the client still comes out significantly ahead of where they would have been had they done no planning, or where they would be if they had a bad (or no) valuation.

Insights: What are the most commonly disputed areas in the valuation that the taxing authority is challenging? How have the nature of the taxing authority challenges changed, if any?

Beard: The amount of discounts for a closely held business is a common dispute. The Service challenges the valuation methodology and value conclusions contained in the appraisal filed with the taxpayer's return.

I have recently seen the Service challenge the methodology used by a valuation analyst where the taxpayer owned both general and limited partner interests in a partnership.

The Service also argued that the discount for lack of marketability (DLOM) should be based on empirical studies other than the studies used by the appraiser.

Damerow: Without question, the most common area of dispute in valuation cases we are seeing is the appropriate DLOM applicable to interests in closely held business entities. This issue arises regardless of whether the company is in fact an operating business or is a holding company consisting of various liquid and illiquid family assets.

Such a challenge likewise applies to tiered-discount situations as well where a client gifts a holding company interest that owns shares in a closely held operating business.

In several audits, we have also seen the Service express a strong, if not complete, preference for applying the net asset value business valuation method, as opposed to the discounted cash flow business valuation method, when determining the value of a noncontrolling ownership interest in a holding company consisting of marketable securities.

Also, as reported many other places, the Service has a strong disdain for valuation discounts on promissory notes for loans between family members.

Insights: Based on your experiences, what advice can you provide estates, family offices, and other intergenerational wealth transferors with regard to (1) estate planning and (2) retaining valuation services?

Beard: An estate plan is similar to a house. Both start with a well-drafted plan. However, the preparation of estate planning documents by an attorney does not mean the estate plan is complete, just like the preparation of house plans by an architect does not mean the house is complete.

I frequently see problems arise from the implementation of an estate plan.

A person should carefully consider his or her fiduciary appointments, such as the executor and trustee. The fiduciary has control over investment and distribution decisions and, thus, is critical to the success of the day-to-day operations of an estate or trust. Incomplete transfers are a common error.

Certain assets, such as real property and entity interests, have specific transfer requirements that should be satisfied to complete a transfer. Reporting errors are another common error. Certain transfers are required to be reported on a federal gift or estate tax return.

The risks associated with reporting can be reduced by satisfying the requirements of a safe harbor, such as the appraisal safe harbor under Section 301.6501(c)-1(f)(3) of the Treasury Regulations.

I typically engage a qualified valuation analyst to prepare an appraisal that meets the requirements of the safe harbor when reporting a significant transfer.

Damerow: With regards to estate planning, most strategies take time to implement. Clients are well served if they are thoughtful about their planning goals and take a long-term approach to their wealth transfer planning. This means beginning the wealth transfer discussion as early as possible and staying engaged throughout the process.

Clients and their professional advisers should always be on the lookout for wealth transfer opportunities, just as they are often on the lookout for opportunities to minimize income taxes.

We also encourage clients to implement a number of strategies over time, such as using GRATs, gifts, and installment sales to grantor trusts, to increase the likelihood that one or more strategies will be successful.

To the extent we can provide it, clients like certainty. With respect to valuations, clients need to know:

- that they have provided adequate disclosures to the Service, via the tax return and its exhibits, to start the statute of limitations running as soon as the return is filed;
- that the valuation positions taken on the return are adequately supported by the analysis in the valuation; and
- in the event of an audit, the client's possible exposure to additional transfer tax based on both valuation discounts taken in the valuation.

Therefore, thoughtful analysis in the valuation is an important component for successful wealth transfer and also in meeting clients' expectations.

Insights: What are your thoughts on the expected proposed regulations under Section 2704 and potentially how will they affect valuation estate planning and disputes with the taxing authority as they relate to valuation services for gift and estate taxes?

Beard: The proposed regulations will be the most important piece of tax law for estate planning since ATRA. The Service is expected to use the regulations as a new approach for challenging discounts associated with closely held businesses.

I anticipate that uncertainties will exist under the new rules, and those uncertainties could potentially lead to litigation similar to the history of Section 2036.

Damerow: The Service has said very little about the substance of the expected proposed regulations under Section 2704. Nevertheless the estate planning community has been abuzz with speculation as to whether the regulations will be limited to certain family situations or broad enough to capture many common planning strategies.

One thing we do know is that the effective date of the proposed regulations is critical. If, as many expect, the regulations have a future effective date, and if the regulations are broad enough to affect many common wealth transfer situations, then we could certainly see clients rush to implement strategies just as we saw at the end of 2012.

On the other hand, if the effective date does not allow time to implement additional planning that would be affected by the proposed regulations, then there will be a sad adviser chorus of "I told you you should have done more planning."

About the only thing we can do now is let our clients know change may be coming and remind them of the potential opportunities available to them today.

Summary and Conclusion

The increase in the federal estate tax exemption has appeared to affect the way in which the Service audits estate tax, gift tax, and generation-skipping transfer tax returns. While fewer estates are taxable, there are more examinations of estates greater than $10 million than before. Also these estates are receiving more scrutiny than ever. There is a greater overall audit risk for taxpayers as well—if a taxpayer is audited for a gift tax return, it is more likely that the Service will continue to audit subsequent gift and estate tax returns for this taxpayer.

The Service also seems to be focused on the elimination of valuation discounts with regard to closely held business interests transferred within an intergenerational (or other intrafamily) wealth transfer.

Along this line, with regard to the expected proposed regulations to Section 2704, the Service has totally abandoned the statutory and judicial definition of fair market value—that is, the price that would be agreed to between a hypothetical (and unrelated) willing buyer and a hypothetical (and unrelated) willing seller.

Insights would like to thank our symposium participants for sharing their experience and expertise with our readers with regard to the current trends in federal gift tax, estate tax, and generation-skipping transfer tax matters.

Notes:

1. Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004).
2. Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005).
3. Estate of Curry v. United States, 706 F.2d 1424 (7th Cir. 1983).
4. Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

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Goodwill Valuation

Continued from page 64

The present value of future income method requires a projection of the subject entity's income-generating capacity. The projection begins with the expiration of the subject entity's current income sources (such as the identified current customers) and continues into perpetuity.

The present value of this prospective income stream (which typically provides for a capital charge or a fair return on all the tangible assets and intangible assets used to service the future customers) indicates a goodwill value.

Using this method, goodwill is the present value of future income earned from the future sales to future (unidentified) customers.

The present value of future income method is a conceptually sound method to value goodwill.

Consistent with the income-based concept of goodwill, this method quantifies and assigns all of the income that cannot be associated with any of the subject entity's tangible assets or identifiable intangible assets.

Goodwill is quantified as the present value of all prospective income that cannot be associated with the current sources of income (for example, the tangible assets and intangible assets that are in place as of the analysis date).

Summary

Valuation analysts are often asked to value a closely held entity's goodwill within a gift tax, estate tax, or generation-skipping transfer tax context. Analysts are also called on to value a business entity's goodwill for income tax or property tax purposes. Those valuations may be performed for tax planning, tax compliance, or tax controversy purposes.

This discussion explained that the income approach is not the only approach to value the subject entity's goodwill. The analyst should carefully consider which valuation approach is appropriate for the subject entity and the subject valuation assignment.

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S Corporation Buyers and Sellers Should Consider Making a Section 338 Election

Robert P. Schweihs

There are a variety of factors that buyers and sellers consider when deciding whether the acquisition of a 100 percent ownership interest in the target company should be structured as a stock acquisition or as an asset purchase. If the target company is an S corporation, there may be a federal income tax election that achieves the best of both worlds. In certain circumstances, the acquisition of the target company equity may be treated as a purchase of the target company assets for federal income tax purposes. That federal income tax election could favorably impact (1) the after-tax sale proceeds to the target company seller and (2) the after-tax cost to the target company buyer.

Introduction

An issue that is controversial among many experienced business valuation professionals is whether the value of a business that has elected to be taxed as an S corporation is worth more than an otherwise equivalent business taxed as a C corporation.

Valuation analysts who support the proposition that an S corporation is always worth more than an otherwise equivalent C corporation point to many factors. One of those factors, asserts these proponents, is that the selling shareholders of an S corporation can freely take advantage of, when selling at least 80 percent of the equity of the S corporation, an election under Internal Revenue Code Section 338(h)(10) (hereinafter called the "Section 338 election").

S corporation shareholders often agree to accept a certain purchase price for their S corporation equity. These S corporation sellers often agree to make the Section 338 election without negotiating for an additional purchase price premium. As a result, those unsuspecting S corporation selling shareholders could pay more in income taxes and suffer an effective price discount instead.

A buyer can structure the offer to buy a 100 percent ownership interest in a target company as either:

1. the nontaxable acquisition of the target company equity or
2. the taxable purchase of the target company assets.

The acquisition of the target company equity is typically an efficient transaction structure. This transactional efficiency is due to the following factors:

1. All of the income-generating capacity of the target company is uninterrupted by the transaction.
2. The buyer controls all of the target company recorded and unrecorded assets and all of the company recorded and contingent liabilities.

The tax basis of the target company assets is typically "carried over" in the nontaxable equity acquisition structure. This tax basis carryover means that the target company assets continue to have the same depreciable tax basis after the transaction that they had before the transaction.

The purchase of the target company assets is an attractive transaction structure in many ways.[1] For the target company buyer, this transaction structure is attractive because the buyer only:

1. purchases specific (i.e., desirable) target company assets and
2. assumes specific (i.e., desirable) target company liabilities.[2]

Purchase of Target Company Assets versus Purchase of Target Company Stock

In an asset purchase transaction structure, for federal income tax purposes, the buyer's tax basis in each acquired asset is set equal to the current (i.e., transaction date) fair market value for each asset.

The fair market value of the target assets is often greater than the depreciated historical cost tax basis of the target assets (i.e., this difference tyipcally represents a "step-up" in the asset tax basis).

In that common event, recovering the purchase price through future depreciation and amortization deductions provides additional after-tax cash flow to the buyer. That transaction structure is more attractive (from an income tax perspective) than the after-tax cash flow in the equity-acquisition structure (where an asset tax basis step-up is not permitted for federal income tax purposes).

In most situations, the tax liability to the seller related to a transaction structured as an asset sale is greater than the tax liability to the seller if the same transaction (at the same purchase price) is structured as an equity sale.

Most sale and purchase transactions involving 100 percent close corporation ownership interests are structured as equity acquisitions.

Section 338(h)(10)

The "Section 338 election" provides a particular federal income tax advantage in transactions involving the sale of an S corporation equity—when compared to the sale of a C corporation equity.[3]

The Section 338 election allows the corporate buyer that acquires the S corporation equity (but only if all of the selling shareholders agree) to treat the transaction as if it was a purchase of the S corporation assets.

The Section 338 election allows the corporate buyer to enjoy the more attractive future depreciation. These depreciation expense deductions are deductions related to the step-up in the tax basis of the purchased assets.

In certain situations, the purchase price for an S corporation can be greater than the purchase price for an identical C corporation.

However, to the seller of the S corporation who receives a premium purchase price as an incentive to agree to the Section 338 election, there may be no additional after-tax benefit related to the tax election agreement.

Making the Section 338 Election

From the seller's income tax perspective, the same amount of total gain will be recognized by the S corporation shareholders in a sale of all of the S corporation outstanding equity as in a sale of all of the S corporation assets (followed by a complete liquidation of the S corporation).

However, in an asset sale (without the benefit of the Section 338 election), income tax is due on the gain on the sale of the target assets. This income tax is paid by the target company (some at ordinary income tax rates). This tax treatment is because the target company (and not the S corporation shareholder) is the seller of the company assets.

Upon liquidation of the target company, the shareholders also pay a second level of income tax on the remaining asset sale proceeds that are distributed to them.

Income Tax Benefits to the Corporate Acquirer

When the Section 338 election is made, the sale of target company equity by the selling shareholders is ignored. Under the Section 338 election, the target company S corporation status remains in effect throughout the deemed sales process.

And, any gain recognized on the deemed sale then flows through to the S corporation shareholders. The S corporation shareholders then adjust their basis in the S corporation equity interest for purposes of determining gain on the deemed liquidation.

Income Tax Costs to the Selling Shareholders

All of the selling shareholders must consent to the Section 338 election. This is because this tax election can reduce the net after-tax proceeds to the selling shareholders.

However, the positive income tax benefits to the buyer—of the step-up in the basis of the acquired assets available under the Section 338 election—is often much greater than the negative income tax attributes to the seller.

In the following example, the difference in the value of the Section 338 election to the buyer (i.e.,

accounting for the transaction as the purchase of assets instead of as an acquisition of equity) is the equivalent of an approximately 14.6 percent discount in the purchase price.

After increasing the purchase price to the seller by the amount of the income tax related to the Section 338 election, the income tax attributes available to the buyer are equivalent to a purchase price premium of approximately 13.3 percent.

In this sense, the value of the target company as an S corporation is greater than the value of the target company as a C Corporation.

Simplified Illustrative Example of a Section 338 Election Cost/Benefit Analysis

Let's assume that a C corporation buyer initially offers to buy the closely held target S corporation equity from the seller for $15.0 million in cash on December 31, 2015.

The company buyer will effectively reduce the transaction purchase price by:

1. convincing the selling S corporation shareholder to agree to the Section 338 election and
2. incentivizing the seller to accept the negative income tax consequences.

The Illustrative Target S Corporation

The most recent information regarding the target S corporation as of December 31, 2015, reflects the following data:

1. The target company has been an S corporation since its inception (more than 10 years ago).
2. The target S corporation uses the cash method of accounting. (This assumption provides a simpler analysis than the analysis using another accounting method; however, the income tax conclusion remains the same).
3. The target company's equipment originally cost $800,000 when it was purchased by the subject S corporation.

   The current fair market value of the target company equipment is equal to its current tax basis of $600,000.
4. The S corporation's ordinary income for the year was $2 million.

   The S corporation's sole shareholder, Jones, has a tax basis in the target company stock of $1 million.
5. The S corporation has an accounts payable balance of $700,000.
6. The S corporation has an accounts receivable balance of $1,000,000.
7. The S corporation has a cash balance of $500,000.

Federal Income Tax Rates

Let's assume that any excess purchase price (i.e., the amount of the purchase price in excess of the equipment fair market value) is attributable to the target company's goodwill.

In addition, let's assume that the selling shareholder Jones is in:

1. the 39.6 percent federal income tax bracket for ordinary income purposes and
2. the 20.0 percent federal income tax bracket for long-term capital gain purposes.

The question for the transaction financial adviser to answer is: does the Section 338 election make sense with regard to the above-described illustrative transaction scenario?

Simplified Illustrative Cost/Benefit Analysis

For simplified illustrative analysis purposes only, this analysis ignores the possible impact of:

1. the alternative minimum tax,
2. state and local income taxes, and
3. any applicable deprecation or other recapture income recognition.

It is important for the transaction participants to consider these additional income tax implications.

There will be no negative built-in gains tax ramifications for the S corporation. This is because the subject company was an S corporation for more than 10 years, and all of the statutory requirements have been met.

Further, let's assume that the subject S corporation is not subject to the excess net passive income tax or the LIFO recapture tax.

The sale of the subject S corporation equity does not cause a termination of its S election status.

However, the S corporation status will terminate on the acquisition date as a result of the acquisition of the subject S corporation equity by a C corporation—that is, an ineligible shareholder.

The Selling Shareholder Income Tax Issues

There are several income tax issues affecting the selling shareholder Jones. For example, the target company operating income of $2 million, which was generated by the S corporation, passes through to Jones as ordinary income whether the Section 338 election is made or not.

Let's assume that the transaction parties make the Section 338 election. The taxable income to shareholder Jones includes the income tax consequences of the deemed sale by the S corporation of all of its assets.

This taxable income flows through to shareholder Jones at the individual taxpayer level.

The Deemed Sale Price

The deemed sale of assets by the target S corporation may be analyzed as follows:

Amount of cash paid to the selling S corporation: $15.0 million

Plus: Accounts payable of the S corporation: $0.7 million

Equals: The aggregate deemed sales price (ADSP)—that is, the amount realized: $15.7 million

The Aggregate Deemed Sale Price

The allocation of the transaction ADSP is summarized as follows:

Attributable to cash: $0.5 million

Attributable to accounts receivable: $1.0 million

Attributable to equipment: $0.6 million

ADSP balance attributable to purchased goodwill: $13.6 million (capital gain)

Income Tax Consequences to the Selling Shareholder

The resulting income tax consequences to selling shareholder Jones may be summarized in the following three components:

1. Flow-through of $2 million in ordinary income from the S corporation for the period before the acquisition:

   $2 million times 39.6% income tax rate = $0.792 million in income tax

2. Ordinary income from the S corporation based on the sale of the company accounts receivable:

   $1 million times 39.6% income tax rate = $0.3 million in income tax

3. The S corporation adjusted stock basis for Jones may be calculated as follows:

   Initial stock basis ($1 million)

   Plus: Ordinary income from the operations ($2.0 million)

   Plus: Ordinary income from sale of accounts receivable ($1.0 million)

   Plus: Capital gain on the sale of goodwill ($13.6 million)

   Equals: The final stock basis of $17.6 million.

The capital loss on the deemed liquidation of the subject S corporation is calculated by comparing:

1. the deemed liquidation proceeds of $15 million with
2. the final stock basis of $17.6 million.

Accordingly, $2.6 million is the long-term capital loss that Jones will report on this transaction.

The capital gains tax rate will be applied to the net long-term capital gain of $11 million. The long-term capital gain results from:

1. the capital gain of $13.6 million on the sale of the company goodwill (as calculated above), minus
2. the capital loss of $2.6 million on the deemed liquidation of the S corporation.

The long-term capital gains tax is $2.2 million ($11 million times 20% long-term capital gains tax rate).

Transaction with the Section 338 Election

Therefore, the total transaction-related federal income tax liability imposed on the selling shareholder Jones after making the Section 338 election is $3.39 million. This federal income tax liability is the sum of the three components noted above.

This analysis assumes that the S corporation cash basis accounts payable totaling $0.7 million is not deductible on its final stub period income tax return. However, a final S corporation tax return income tax deduction may be justifiable.

Now, let's assume that the Section 338 election is not made in this transaction.

Transaction without the Section 338 Election

Assuming that he does not make the Section 338 election, the income tax ramifications for shareholder Jones can be summarized in two components:

1. Flow-through of the $2 million ordinary income from the S corporation for the period before the acquisition:

   $2 million times 39.6% income tax rate = $0.792 million in income tax

2. Long-term capital gain tax on the sale of the S corporation equity which has an adjusted tax basis of $3 million (i.e., an initial stock basis of $1 million plus ordinary income from operations of $2 million).

   The sale proceeds of $15 million minus the stock basis of $3 million yields a long-term capital gain of $12 million:

   $12 million times 20% long-term capital gain tax rate = $2.4 million in income tax

Therefore, if shareholder Jones does not make the Section 338 election related to this transaction, then his total federal income tax liability would be $3.19 million.

Section 338 Election Cost/Benefit Analysis

Based on the above-described analysis and calculations, it may be advisable for shareholder Jones to not agree to make the Section 338 election related to the sale transaction.

That is, in this illustrative example, Jones will save $196,000 in after-tax dollars by not agreeing to make the Section 338 election.

The Section 338 election must be made jointly by the buyer C corporation and the seller S corporation. And, the Section 338 election tax election forms must be signed by all of the S corporation shareholders.

In this illustrative example, Jones should use this information as a negotiation tool to maximize both the tax and the nontax issues related to the proposed sale transaction.

The positive income tax consequence of the Section 338 election to the buyer C corporation is the ability to amortize $13.6 million of the purchase price (i.e., the goodwill value) over a 15-year Section 197 amortization period.

This goodwill value represents an annual amortization deduction of more than $900,000. At a 36.9 percent C corporation income tax rate, the annual income tax benefit would be $359,000.

And, at a present value discount rate of 17.5 percent, this amortization tax deduction represents a savings from the Section 338 election to the buyer C corporation of more than $2.19 million.

If the buyer C corporation provides an incentive to Jones by paying him an extra purchase price amount of $196,000 to offset the negative Section 338 tax consequence—then the buyer C corporation could recognize the positive income tax consequences of the Section 338 election.

By convincing the selling S corporation shareholder to agree to the Section 338 election (i.e., by increasing the purchase price by the tax consequences of $196,000), the buyer increases after-tax cash flow by a present value of more than $2 million.

This $2 million cash flow benefit represents an effective price discount from the original $15,000,000 purchase price of 13.3 percent.

The extra $196,000 purchase price would become part of the capital gain to seller Jones, and it would become part of the amortizable goodwill amount to the buyer C corporation.

So, after recomputing these figures to include this $196,000 purchase price incremental adjustment, the economic benefit due to the Section 338 election in this example increases.

Of course, selling shareholder Jones does not have to agree to make the Section 338 election.

Based on the above-listed facts (and indicated assumptions), the purchase price premium from the buyer C corporation for agreeing to the Section 338 election is $196,000.

Summary and Conclusion

Based solely on an additional $196,000 in the offered purchase price, Jones is indifferent from a financial standpoint. To Jones, even though the purchase price increases by 1.3 percent, he will receive no after-tax price premium related to his company's S corporation tax status.

Jones could try to negotiate the transaction to receive an additional portion of the buyer's income tax benefit attributable to the Section 338 election.

That income tax benefit is not available to either the buyer or to the seller without the seller's acquiescence.

A Section 338 election cost/benefit analysis—such as the one illustrated in this discussion—should include an estimate of the fair market value of all of the assets of the seller S corporation.

Continued to page 86

Valuation of Contract-Related Intangible Assets

Robert F. Reilly, CPA

The valuation of contract-related intangible assets is often an issue in matters related to income tax, gift tax, estate tax, generation-skipping tax, and property tax. This discussion explains the different types of contract intangible assets. This discussion summarizes the generally accepted approaches and methods related to the valuation of contract intangible assets. Finally, this discussion presents an illustrative example of the valuation of the hypothetical Taxpayer Corporation contract intangible asset.

Introduction

There are many reasons why a taxation matter may involve the valuation of a contract-related intangible asset. These reasons include gift tax, estate tax, generation-skipping transfer tax, income tax, and property tax. And, such valuations may be used for taxation planning, compliance, appeals, and litigation.

This discussion summarizes the common methods related to contract valuation.

In addition, this discussion:

1. describes the factors that are commonly considered in the contract valuation,
2. summarizes both the internal and external data sources that are commonly considered in the valuation, and
3. presents an illustrative example of a contract valuation.

Contract-Related Intangible Assets

A contract is typically considered to be an agreement between two or more parties creating obligations that are legally enforceable or otherwise recognizable under the law. Analysts often look at the actual writing of the contract that sets forth the agreement of the parties.

Contract Analysis Due Diligence

The analyst understands that a contract can be oral as well as written. The analyst will typically consult with counsel regarding the legal enforceability of an oral contract.

Alternatively, a contract may be considered a promise or a set of promises either:

1. the breach of which the law provides a remedy for or
2. the performance of which the law recognizes as a duty.

In this construct, a contract may be viewed as a legal duty or set of duties that is not imposed by the law of tort.

A contract is also an enforceable agreement between two or more parties to either do a thing (or a set of things) or to not do a thing (or a set of things). The analyst considers the rights and duties encompassed in the contract.

The contract document (or the oral agreement) itself is not the intangible asset. The legal rights and duties of the contract are the intangible asset.

Before any valuation can be performed, there should be an enforceable contract. In order for the contract to be enforceable, it should meet certain legal requirements.

The parties to the contract should be competent to enter into such a contract. The subject matter should be legally appropriate for a contract. There should be consideration given in the contract. There should be a mutuality of agreement and a mutuality of obligation.

The analyst should consult with legal counsel if there is a question as to whether the subject contract meets the requisite legal requirements.

The analyst considers the specific terms of a specific contract. The specific contract terms typically include the contract start date and stop date. The contract intangible asset valuation is typically limited to the terms of the contract agreement itself.

Contracts and Expected Contract Renewals

There is a related intangible asset to the contract: the expected contract renewals. The expected contract renewals intangible asset generally represents the expectation that an individual contract will be renewed at the end of its stated contract term or expiration.

The contract parties may expect that the current, let's say, five-year term contract will renew for a second, third, fourth, and so on, five-year period after the current contract term expires.

If this expectation is reasonable, the analyst may be asked to assess the two intangible asset components of the relationship between the contract parties:

1. The current contract (with a stated or implied termination date)
2. The expected contract renewals that may occur after the termination of the current contract agreement

Some analysts consider the current contract and the expected contract renewals to be two separate but related intangible assets. For some purposes, it may be important to separately analyze these two intangible assets.

For example, each of these two intangible assets may have a different expected remaining useful life (RUL):

1. The current five-year term contract may expire in two years.
2. The expected renewal of the five-year term contract will expire in seven years.

Some analysts consider both intangible asset components to represent a single intangible asset that may be called contracts and expected contract renewals. In some situations, it may be appropriate to collectively analyze both of the value components as a single intangible asset.

Before performing any quantitative analysis, the analyst should decide if the valuation subject is (1) the current contract only or (2) the current contract and the expected contract renewals. The analyst may accept direction from counsel in making this determination.

Contract Valuation Approaches and Methods

All intangible asset valuation approaches may be applicable to most contract valuations.

This section summarizes the common contract valuation methods within each of the three generally accepted intangible asset valuation approaches.

The Cost Approach Contract Valuation Methods

In the cost approach, the analyst often uses the replacement cost new less depreciation (RCNLD) method to value contracts. In such an analysis, the direct cost and indirect cost components are generally not the greatest components of the contract value.

Direct costs typically include the labor and overhead costs related to the company employees who negotiate and consummate the contract or who apply for and process the license document. Indirect costs typically include the out-of-pocket expenses related to legal counsel, engineers, consultants, and others retained to help negotiate the contract or obtain the license.

The developers' profit cost component typically includes a fair profit margin applied to the sum of the direct and indirect costs.

Entrepreneurial incentive is typically the most important component of the RCNLD method of contract valuation. Entrepreneurial incentive is often considered to be an opportunity cost. This opportunity cost is often measured as the owner/operator's lost profits during the contract replacement period.

If the analyst expects that it would take, for example, six months to replace the subject contract, then the entrepreneurial incentive may include six months of lost profits during the contract replacement period.

This replacement period typically includes the time period between when the owner/operator first

decides to enter into a contract or obtain a license and when the new contract or license is in place and fully functioning.

In other words, the replacement period includes the time required to negotiate and consummate a new contract or apply for and receive a new license agreement.

The lost income during the replacement period is typically measured as the difference between:

1. the income that the owner/operator will actually earn with the actual contract or license during the replacement period and
2. the income that the owner/operator would have earned without the contract or license in place during the replacement period.

This lost income, or opportunity cost, component of the entrepreneurial incentive is often the largest portion of the contract valuation RCNLD.

The Market Approach Contract Valuation Methods

In the market approach, the analyst often uses the comparable uncontrolled transaction (CUT) method based on either arm's-length sales of guideline intangible assets or arm's-length licenses of guideline intangible assets.

That is, for certain types of licenses and permits, there may be an actual marketplace for the arm's-length sales of such intangible assets between third parties.

For example, the analyst may be able to assemble empirical data regarding the arm's-length sales of FCC broadcast and spectrum licenses and television and radio network affiliation agreements.

In addition, for certain types of government-issued or private franchises, there may be an actual marketplace for the arm's-length license of such intangible assets between third parties.

For example, the analyst may be able to assemble empirical data regarding the arm's-length license of cable television franchise agreements, hotel and hospitality franchise agreements, and restaurant and food service franchise agreements.

The Income Approach Contract Valuation Methods

In the income approach, the analyst may use a number of different valuation methods. These methods include the following:

1. The present value of the incremental income related to the contract
2. The present value of the differential income related to the contract
3. The present value of the excess (or residual) income related to the contract
4. The present value of the profit split income related to the contract
5. The present value of the residual profit split income related to the contract

In the application of any of these income approach methods, the analyst considers the following:

1. The income (however measured) that can be directly associated with the contract intangible asset
2. The income that is expected to be earned over the contract intangible asset's RUL

Another common income approach method is for the analyst to compare the value of the owner/operator business with the contract in place to the value of the owner/operator business without the contract in place.

The difference between the two business value estimates (which should equal the present value of the contract-related income) provides an indication of the contract intangible asset value.

Factors to Consider in the Contract Valuation

Exhibit 1 presents some of the factors that the analyst typically considers in the contract intangible asset valuation.

Exhibit 1
Factors Commonly Considered in the Contract Intangible Asset Valuation

1. The degree of legal enforceability of the contract or agreement
2. The state law under which the contract is binding
3. The specific terms of the agreement, including the rights, duties, and obligations of each of the parties
4. The expected amount of time required to negotiate a new contract (or to obtain a new license or permit)
5. The degree to which the contract is transferable
6. The degree to which the contract is assignable
7. The party's ability to create or support subcontractors or sublicenses
8. The legal term of the agreement (the contract start date and termination date)
9. The provisions (if any) for a renewal or extension of the agreement
10. The schedule of any payments associated with the contract
11. Whether the determination of contract payments is fixed or variable
12. Does the contract specify that it contains all of the agreements between the parties?
13. Does the contract refer to (and does it depend on) any other contract or agreement between the parties?
14. Is this type of contract between the parties common or unique? (Do all company customers, suppliers, or employees have similar contracts?)
15. Has the contract or agreement ever been tested in court?
16. Does the contract mention (or quantify) liquidation damages?
17. Does the contract describe what happens in the case of a contract dispute (mediation, arbitration, and litigation)?
18. What is the degree of standardization (for example, a standard real estate lease) or uniqueness (a celebrity performance agreement) of the contract?
19. How comparable is the contract to other contracts (of the parties or in the industry)?
20. What did the parties do before the contract? What would the parties do without the contract?

Internal and External Data Sources

Most of the documents and data sources that the analyst may rely on in the contract valuation are internal to the intangible asset owner/operator.

Internal Data Sources

Generally, those internal data sources include the following:

1. A copy of the subject contract, permit, or license
2. Information about the direct and indirect costs to negotiate the contract or apply for the license
3. The amount and duration of time required to negotiate the contract or apply for the license
4. Historical financial statements for a reasonable time period before the agreement was in place
5. Historical financial statements for the time period since the agreement has been in place
6. Prospective financial statements for the RUL of the contract or agreement
7. Pro forma financial statements that would represent the expected results of the owner/operator without the contract or agreement
8. Pro forma financial statements that would represent the expected results of the owner/operator with a damaged contract or agreement
9. Data regarding any owner/operator revenue, expense, or investment metrics that can be directly associated with the contract or agreement, including the following:
   - Fixed revenue, expense, or investment metrics
   - Variable revenue, expense, or investment metrics

- Total revenue, expense, or investment metrics

10. Information about the owner/operator's historical (and planned, if available) renewals of the contract, license, or permit

External Data Sources

Some of the documents and data that the analyst may rely on in the contract valuation may come from external sources; that is, these data may relate to selected guideline companies, selected contract license or transfer transactions, or selected owner/operator industry sources.

The general categories of these external data sources include the following:

1. Guideline publicly traded company financial statements (typically SEC filings) for the time period
   - before the valuation date,
   - during the damages period, or
   - before the transfer price calculation date.
2. Sales of guideline licenses, permits, or franchises
   - between the private issuer and private parties (new agreements),
   - between a government agency and private parties (new agreement), or
   - between private parties (seasoned agreements).
3. Licenses of guideline licenses, permits, or franchises
   - between the private issuer and private parties (new agreements),
   - between a government agency and private parties (new agreement), or
   - between private parties (seasoned agreements).
4. Information from government agencies or regulatory authorities about
   - the expected (or actual) costs of a license/permit application and
   - the expected (or actual) time period of a license/permit application.
5. Owner/operator industry data regarding
   - revenue or profit growth rates,
   - cost and expense ratios,
   - profit margins,
   - returns on investment,

   - required levels of investment, and
   - average costs of capital.

If such data are available, the analyst may rely on the following data from the contract counterparty:

1. Revenue or profit growth rates
2. Cost and expense ratios
3. Profit margins
4. Returns on investment
5. Required levels of investment
6. Costs of capital

Contract Valuation Illustrative Example

This discussion section presents the facts of the illustrative contract valuation, the contract valuation analysis, and the contract value conclusion.

The Illustrative Analysis Fact Set

The analyst is retained to estimate the fair value of the assets of Taxpayer Corporation ("Taxpayer") as of May 2, 2013. One of the Taxpayer assets is an employment agreement that includes a noncompete covenant with Fred Founder ("Fred").

Fred is one of the founders of this closely held taxpayer company, and he is a key employee of the company. Taxpayer designs and manufactures customized furniture.

Fred has important relationships with the Taxpayer customers, suppliers, and employees. According to his employment agreement, Fred may not compete against Taxpayer in the furniture design and manufacture industry for 10 years after his last date of employment.

The Illustrative Valuation Methodology

The analyst decided to use the income approach and the comparative business enterprise value method to estimate the value of the noncompete agreement. The analyst decided to use the discounted cash flow (DCF) method to value the Taxpayer business enterprise. Using this business valuation method, the analyst compared the following two scenarios:

1. Scenario 1: the value of the Taxpayer business with the subject contract in place and without competition from Fred
2. Scenario 2: the value of the Taxpayer business without the contract in place and with the expected amount of competition from a noncontractually obligated Fred

The Contract Valuation Analysis

The analyst discussed with management the expected impact on the Taxpayer revenue if Fred were to compete against the company. The analyst concluded that it would take minimal time (two weeks) for Fred to:

1. develop competing products,
2. acquire the necessary tooling to manufacture the products (or to have the product manufactured),
3. ramp-up production of the competing products,
4. re-establish customer relationships, and
5. begin selling the products into the market.

As a result, the analyst estimated that, absent the noncompete agreement, Fred could effectively start to compete with Taxpayer almost immediately.

The analyst considered the age, health, financial resources, and geographic reach of Fred. The analyst estimated that if Fred were to compete, his competition could reduce the projected Taxpayer revenue by approximately 50 percent.

In addition, based on discussions with management, the analyst estimated that there was a material probability that Fred would compete if he was not contractually prohibited from doing so. In consultation with management, the analyst estimated this probability at 75 percent.

The analyst also estimated that if Fred competed against Taxpayer, the company would experience employee turnover. That employee turnover would result in an increase in operating expenses in year one due to an increase in employee recruiting and training expense.

This expense would increase because current employees would be expected to leave the company and work for Fred.

These two sets of projection variables (that is, a 75 percent probability that Taxpayer would experience a 50 percent reduction in revenue) result in a reduction in the revenue in year one of the projection period of approximately 30 percent (compared to the revenue reported for the prior year).

Exhibit 2 presents management's projected income statements and cash flow for the fiscal years ended December 31, 2013, through December 31, 2022. These projections are based on the premise that the noncompete agreement is in place.

The projected operating income, depreciation expense, capital expenditures, and net working capital requirements were provided by management.

Taxpayer will continue to generate cash flow beyond fiscal 2022. In order to capture the value represented by the cash flow generated beyond 2022, the analyst's DCF valuation incorporates a terminal value.

The analyst estimated the terminal value using the Gordon growth model. That terminal value model is based on the premise that, after the discrete projection period, the net cash flow will increase at a constant rate of 2 percent per year into perpetuity.

As presented in Exhibit 2, the value of the Taxpayer business enterprise (that is, the total invested capital) under the scenario 1 analysis is approximately $28.6 million.

Contract Valuation Synthesis and Conclusion

Exhibit 3 presents the analyst's adjustments to management's projected income statements and net cash flow under the premise that Fred's covenant is not in place.

In the scenario 2 analysis, the projected revenue was based on:

1. the revenue that Fred would divert from Taxpayer,
2. the probability of Fred competing against Taxpayer (75 percent), and
3. the fact that if Fred were to compete, he could likely reduce the projected revenue by approximately 50 percent.

As presented in Exhibit 3, the value of the Taxpayer business enterprise (that is, the total

Exhibit 2
Taxpayer Corporation
Business Enterprise Value
Scenario I: With the Noncompete Covenant in Place
As of May 2, 2013

	Projected Fiscal Year Ended December 31,									
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Discrete Projection Period Net Cash Flow (NCF):	$000	$000	$000	$000	$000	$000	$000	$000	$000	$000
Net Revenue	33,841	38,071	41,878	46,066	50,673	54,220	58,015	62,076	6,422	71,071
Cost of Sales	23,350	26,524	29,453	32,707	36,317	39,038	41,771	44,695	47,824	51,171
Gross Profit	10,491	11,547	12,425	13,359	14,356	15,182	16,244	17,381	18,598	19,900
Operating Expenses	6,364	6,990	7,621	8,311	9,068	9,664	10,299	10,978	11,702	12,476
Operating Income	4,127	4,557	4,804	5,048	5,288	5,518	5,945	6,403	6,896	7,424
Other Expenses	(2,994)	(4,021)	(3,937)	(3,892)	(3,810)	(3,627)	(3,479)	(3,317)	(3,271)	(3,350)
Pretax Income	1,134	536	831	1,156	1,478	1,891	2,466	3,086	3,625	4,074
Income Taxes	452	214	332	461	590	754	984	1,231	1,446	1,625
Net Income	682	322	499	695	888	1,137	1,482	1,855	2,179	2,449
Net Operating Income	1,485	1,056	1,159	1,257	1,343	1,476	1,693	1,927	2,179	2,449
Calculation of NCF:										
Less: Capital Expenditures	(254)	(286)	(314)	(345)	(380)	(271)	(290)	(310)	(332)	(355)
Plus: Depreciation and Amortization Expense	1,167	2,280	2,315	2,349	2,382	2,402	2,410	2,424	2,441	2,461
Less: (Increase) Decrease in Net Working Capital	1,034	(847)	133	151	168	124	116	124	132	142
Net Cash Flow	3,433	2,203	3,293	3,412	3,513	3,731	3,929	4,165	4,420	4,697
Adjustment Factor [a]	0.67	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Adjusted NCF	2,300	2,203	3,293	3,412	3,513	3,731	3,929	4,165	4,420	4,697
Present Value Factor @ 15% [b]	0.9543	0.8491	0.7384	0.6421	0.5583	0.4855	0.4222	0.3671	0.3192	0.2776
Present Value of NCF	2,195	1,871	2,431	2,191	1,962	1,811	1,659	1,529	1,411	1,304
Present Value of Discrete Period NCF	18,364									

Present Value of Terminal Period NCF:

	000
2023 NCF [c]	$ 4,791
Direct Capitalization Rate [d]	13%
Terminal Value	36,853
Present Value Factor	0.2776
Present Value of Terminal Period NCF	$ 10,230

Conclusion of Business Enterprise Value with the Noncompete Covenant:

	000
Present Value of Discrete Period NCF	$ 18,364
Present Value of Terminal Period NCF	10,230
Business Enterprise Value with the Noncompete Covenant in Place	$ 28,594

Footnotes:

[a] Reflects a valuation date of May 2, 2013.

[b] Calculated as if NCF received at midyear.

[c] Based on a NCF expected long-term growth rate of 2%.

[d] Equals the 15% discount rate minus the 2% expected long-term growth rate.

Exhibit 3, Page 1
Taxpayer Corporation
Business Enterprise Value
Scenario II: Without the Noncompete Covenant in Place
As of May 2, 2013

	Projected Fiscal Years Ended December 31,				
	2013	2014	2015	2016	2017
Discrete Projection Period Net Cash Flow (NCF) [a]	$000	$000	$000	$000	$000
Total Revenue [b]	33,841	38,071	41,878	46,066	30,673
Revenue Adjustment if Competition [c]	50%	50%	50%	50%	50%
Probability of Effectively Competing	75%	75%	75%	75%	75%
Adjusted Revenue [d]	21,151	23,794	26,174	28,791	31,671
Cost of Sales	14,594	16,578	18,408	20,442	22,698
Gross Profit	6,557	7,217	7,766	8,349	8,973
Operating Expenses [e]	4,478	4,369	4,763	5,194	5,668
Operating Income	2,079	2,848	3,003	3,155	3,305
Other Expenses	(2,372)	(2,967)	(2,891)	(2,779)	(2,661)
Pretax Income [h]	(292)	(119)	112	376	644
Income Taxes	(116)	(47)	45	150	257
Net Income	(176)	(71)	67	226	387
Debt-Free Net Income	628	664	728	769	843
Calculation of NCF:					
Less: Capital Expenditures	(159)	(179)	(196)	(216)	(238)
Plus: Depreciation and Amortization Expense	729	1,425	1,447	1,468	1,489
Less: (Increase) Decrease in Net Working Capital	646	(529)	83	94	105
Net Cash Flow:	1,845	1,380	2,062	2,136	2,199
Adjustment Factor [f]	0.67	1.00	1.00	1.00	1.00
Adjusted NCF	1,236	1,380	2,062	2,136	2,199
Present Value Factor @ 15% [g]	0.9543	0.8491	0.7384	0.6421	0.5583
Present Value of NCF	1,179	1,172	1,522	1,371	1,228
Present Value of Discrete Projection Period NCF	11,301				

Present Value of Terminal Period NCF:

	000
2023 NCF [i]	$ 2,998
Direct Capitalization Rate [j]	13%
Terminal Value	23,060
Present Value Factor	0.2776
Present Value of Terminal Period NCF	$ 6,401

Indicated Fair Value of the Noncompete Covenant:

	000
Present Value of Discrete Period NCF	$ 11,301
Present Value of Terminal Period NCF	6,401
Business Enterprise Value without the Noncompete Covenant in Place	17,702
Business Enterprise Value with Noncompete Covenant	$ 28,594
Less: Business Enterprise Value without Noncompete Covenant	17,702
Equals: Preliminary Value of Noncompete Covenant	10,892
Tax Amortization Benefit Adjustment [k]	1.20
Fair Value of the Noncompete Covenant	$ 13,069
Fair Value of the Noncompete Covenant (rounded)	$ 13,100

Footnotes:

[a] Reflects a valuation date of May 2, 2013.

[b] Based on management projections.

[c] Based on the projection that if Fred were to compete, he would be able to capture 50 percent of the Taxpayer business.

[d] Calculated as: total revenue minus (total revenue × revenue adjustment if Fred competes × probability of effectively competing).

[e] Operating expenses in fiscal year 2013 are estimated to increase by $500,000 due to an increase in recruiting and training workforce costs; this increase assumes that some current employees may leave to work with Fred.

[f] Reflects a valuation date of May 2, 2013.

[g] Calculated as if NCF received at midyear.

[h] Based on the same margin as in Exhibit 2, except for interest expense margin, interest income margin, and income tax margin. Interest expense and interest income is the same as the projections in Exhibit 2. Income tax is calculated as pretax income × 40 percent income tax rate.

[i] Based on an NCF expected long-term growth rate of 2%.

[j] Equals the 15% discount rate minus the 2% expected long-term growth rate.

[k] Based on a 15-year statutory amortization period, a 40 percent income tax, and a 15 percent discount rate.

Exhibit 3, Page 2
Taxpayer Corporation
Business Enterprise Value
Scenario II: Without the Noncompete Covenant in Place
As of May 2, 2013

	Projected Fiscal Years Ended December 31,				
	2018	2019	2020	2021	2022
Discrete Projection Period Net Cash Flow (NCF) [a]	$000	$000	$000	$000	$000
Total Revenue [b]	54,220	58,015	62,076	66,422	71,071
Revenue Adjustment if Competition [c]	50%	50%	50%	50%	50%
Probability of Effectively Competing	75%	75%	75%	75%	75%
Adjusted Revenue [d]	33,888	36,259	38,798	41,514	44,419
Cost of Sales	24,399	26,107	27,934	29,890	31,982
Gross Profit	9,489	10,153	10,863	11,624	12,438
Operating Expenses [e]	6,040	6,437	6,861	7,314	7,798
Operating Income	3,449	3,716	4,002	4,310	4,640
Other Expenses	(2,474)	(2,302)	(2,114)	(2,040)	(2,089)
Pretax Income [h]	975	1,414	1,888	2,270	2,551
Income Taxes	389	564	753	905	1,017
Net Income	586	850	1,136	1,365	1,534
Debt-Free Net Income	925	1,062	1,208	1,365	1,534
Calculation of NCF:					
Less: Capital Expenditures	(169)	(181)	(194)	(208)	(222)
Plus: Depreciation and Amortization Expense	1,501	1,506	1,515	1,526	1,538
Less: (Increase) Decrease in Net Working Capital	78	73	78	83	89
Net Cash Flow:	2,335	2,459	2,607	2,766	2,939
Adjustment Factor [f]	1.00	1.00	1.00	1.00	1.00
Adjusted NCF	2,335	2,459	2,607	2,766	2,939
Present Value Factor @ 15% [g]	0.4855	0.4222	0.3671	0.3192	0.2776
Present Value of NCF	1,134	1,038	957	883	816

Footnotes:
[a] Reflects a valuation date of May 2, 2013.
[b] Based on management projections.
[c] Based on the projection that if Fred were to compete, he would be able to capture 50 percent of the Taxpayer business.
[d] Calculated as: total revenue minus (total revenue × revenue adjustment if Fred competes × probability of effectively competing).
[e] Operating expenses in fiscal year 2013 are estimated to increase by $500,000 due to an increase in recruiting and training workforce costs; this increase assumes that some current employees may leave to work with Fred.
[f] Reflects a valuation date of May 2, 2013.
[g] Calculated as if NCF received at midyear.
[h] Based on the same margin as in Exhibit 2, except for interest expense margin, interest income margin, and income tax margin. Interest expense and interest income is the same as the projections in Exhibit 2. Income tax is calculated as pretax income × 40 percent income tax rate.

invested capital) under the scenario 2 analysis is approximately $17.7 million.

Contract Intangible Asset Value Conclusion

Based on the difference in the business value indications calculated under each scenario, and after consideration of the tax amortization benefit (TAB) adjustment factor, the fair value of Fred's noncompete covenant is approximately $13.1 million.

The TAB factor results from the present value of the federal income tax deductions related to the amortization of the noncompete covenant value (that is, as an Internal Revenue Code Section 197 intangible asset) over a statutory 15-year period.

Accordingly, the value of Fred's noncompete covenant, as of May 2, 2013, is $13.1 million.

Summary

The value of contract intangible assets is often an issue in income tax, gift and estate tax, and property tax matters. These contract valuation analyses arise in the contexts of tax planning, tax compliance, and tax controversy.

This discussion summarized the procedures related to the valuation of contract-related intangible assets. This category of intangible assets includes the following:

1. Contracts
2. Agreements
3. License
4. Permits
5. Leases

This discussion explained some of the attributes that are typically present in a contract intangible asset.

This discussion presented:

1. the most common contract valuation methods,
2. the factors that analysts typically consider in the contact analysis, and
3. an illustrative example of a contract valuation (that is, the valuation of an executive's noncompete agreement).

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Section 338 Election

Continued from page 76

Such a Section 338 election cost/benefit analysis should help the seller (and the buyer) to negotiate a more favorable:

1. transaction purchase price and
2. transaction income tax structure.

Agreeing to make the Section 338 election is not a costless decision for the sellers of an S corporation. S corporations are not automatically worth more than an otherwise equivalent C corporation at the point in time that the S corporation shareholder exits his or her investment. The sellers of an S corporation could be worse off if they agree to sell equity and, without recognizing the tax consequences, agree to make the Section 338 election.

Only under certain circumstances and only when the selling shareholders understand those circumstances might the S corporation be worth more than if the business was taxed as a C corporation. The selling S corporation shareholders might be able to negotiate for that premium price by agreeing to make the Section 338 election.

Notes:

1. For purposes of this discussion, nontax issues and the seller's income tax attributes will not be considered. Nontax issues include the possibility that some assets would not be transferable (e.g., certain contracts, leases, and licenses) from the seller to the buyer. When assets are sold, the selling company's income tax attributes stay with the selling company. Such income tax attributes include net operating loss carryovers. In addition, other income tax attributes may be permanently lost. State and local income taxes may be due upon the sale of assets. Such state and local income taxes may not be due in a transaction involving the sale of equity.
2. For example, contingent liabilities (such as potential lawsuits over previous activities of the target company) remain the responsibility of the selling company and, in the purchase of assets, may be avoided by the buyer.
3. That is, the sale of at least 80 percent of the equity.

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Structuring the Selling Employee/ Shareholder Transition Period Payments after a Closely Held Company Acquisition

Robert F. Reilly, CPA

Corporate acquirers often acquire closely held target companies. In such acquisitions, it is common for the corporate acquirer to want to retain the services of the target company selling employee/shareholders. This discussion summarizes the many reasons why corporate acquirers would want to retain the selling employee/shareholders' services during some post-acquisition transition period. However, both the structuring and the characterization of such transition period payments have income tax consequences both (1) to the corporate acquirer and (2) to the selling employee/shareholders. This discussion explains those income tax consequences to both transaction participants.

Introduction

In the acquisition of a closely held services company, it is common for the company acquirer to request that any individual employee/shareholder sellers agree to continue to work for the acquired company during a specified transition period.

This type of employee/seller transition period employment is common in the acquisition of both:

1. professional services practices (such as accounting firms and medical practices) and
2. other services-related companies (such as construction companies and architectural and engineering firms).

The term of the post-transaction seller employment is typically a matter of negotiation between the company acquirer and the company sellers.

Post-transaction seller employment transition periods of one to two years are common. However, longer post-transaction seller employment transition periods are not uncommon.

In such services-related companies (and particularly in closely held companies), the employee/shareholder sellers often have direct contact with the company's clients or customers. For example, in the case of a construction company, the clients may have a direct and personal relationship with the individual company owner/contractor.

Although no longer a stockholder in the acquired company, that individual contractor may continue working for the construction company for a time period until all clients become comfortable with the new owner.

In addition, the illustrative construction company seller may have personal relationships with all of the company's construction industry specialty subcontractors.

Again, the selling shareholder may continue working for the acquired company for a time period in order to successfully transition all of the subcontractor relationships to the new owner.

Finally, the illustrative construction company seller may have personal relationships with all of the company's employees and tradespeople. The selling shareholder may continue working for the acquired company for a time period in order to ensure the smooth transition of these employee and tradespeople relationships to the new owner.

Of course, the employee/shareholder sellers would expect to be fairly compensated for their professional services during the transition period employment.

And, the acquirer company will want to fairly compensate the selling employee/shareholders in order to ensure an efficient ownership transition and a successful company acquisition.

Alternative Transition Period Payment Transaction Structures

The following two questions relate to such post-transaction transition period payments:

1. How much should the company buyer pay to the employee sellers for these transition period services?
2. How should these transition period payments be structured?

Of course, the answer to the first question is based on the unique facts and circumstances of each individual deal. The amount of such transition period payments is typically based on direct negotiations between the company acquirer and the selling employee/shareholders.

The amount of agreed-upon transition period payments will depend on the following:

1. The actual amount of services the sellers will provide to the buyer
2. The buyer's perception of the risk associated with transferring the acquired business operations
3. The sellers' opportunity cost (i.e., how much they could earn through alternative employment opportunities)

This buyer/seller negotiation should be conducted—and the transition period payment terms should be agreed to—before the company acquisition is closed.

The answer to the second question will have direct federal income tax consequences to both the company acquirer and to the employee/shareholder sellers. And, related to this transition period payment structuring issue, these two transaction parties (buyer versus sellers) have adverse income tax consequences to each other.

Therefore, the question of the structure of the employee/sellers transition period payments is the subject of this discussion.

Basically, the two alternative payment structures are as follows:

- The payments could be considered to be employee compensation for the transition period services provided by the former shareholders. This structure raises the question: what is a reasonable amount of employee compensation for the services rendered?
- The payments could be considered to be an earn-out provision that is part of the overall company (whether a stock deal or an asset deal) purchase price. This structure raises the question: what is the total amount of the deal purchase price that the acquirer paid for the target company business?

In addition to tax counsel and legal counsel, a valuation analyst is often involved in answering these two transaction structure questions.

This involvement is because the valuation analyst can assist in answering both questions:

1. What is the amount of reasonable compensation to pay to the selling shareholders?
2. What is the fair price to pay for the value of the acquired company?

Buyer Tax Considerations versus Seller Tax Considerations in Structuring the Transition Payments

The transaction structuring issue is whether the transition period payments to the company sellers represent either:

1. a contingent purchase price amount or
2. employment compensation for services provided by the sellers.

In certain circumstances, the total transition period payments could be considered to include components of both:

1. a contingent purchase price component and
2. employment compensation for services component.

There is an inherent conflict of economic interest between these two alternative transition period payment structures. This is because, from an income tax perspective, either transition period payment characterization will benefit only one party (i.e., the buyer or the sellers) to the acquisition transaction.

From the business sellers' perspective, if the employee/sellers are individuals and the transition period payment is characterized as compensation (including a payment for transition services and for any covenant not to compete), then the payment will be subject to federal income tax—at an income tax rate of up to 39.6 percent.

In addition, these transition period compensation payments will be subject to the employee portion of FICA and to a state income tax.

On the other hand, any transition period payment that is characterized as deferred purchase price (for either the company stock or the company assets) will generally be more attractive to the sellers for income tax purposes.

This is because transition period payments characterized as deferred franchise price will:

1. be subject to the lower capital gains tax rate and
2. not be subject to payroll tax withholding.

Therefore, the company sellers would generally prefer the capital gains tax treatment on any transition period payments.

From the business buyer's perspective, it may be advantageous to characterize the transition period payments as employee compensation for services. This is because the payment of employee compensation will usually generate a current income tax deduction for the acquired company.

Nonetheless, if characterized as employee compensation, the transition period payments may also be subject to the Internal Revenue Code Section 280G deduction limitation on golden parachute payments.

And, such transition period payments would have to comply with Section 409A (i.e., income inclusion for nonqualified retirement plans), requiring the consideration of any collateral provisions.

Factors to Consider in the Structuring of the Transition Payments

Several factors should be considered by the transaction participants when characterizing whether the transition period payments are contingent purchase price earn-out payments or employee compensation for services payments.

These factors include, but are not limited to, the following considerations:

- The transition services conditions. Generally, if the transition period payments are conditioned on the future services that are actually provided by the employee/sellers, then this factor may indicate that the payments should be characterized as employee compensation (consider, for example, the judicial decision in *Duberstein*, 363 U.S. 278 (1960)).
- The proportionality of the transition payments. The transaction parties should consider whether the transition period payments are proportional to the sellers' prior ownership of the company stock.

  That is, if there is proportionality—if all of the sellers receive the transition period payments based on the services provided but only some of the selling employee/shareholders—then this factor may indicate that the transition payments should be characterized as a return on capital and as a deferred purchase price.
- The negotiations between the transaction parties. The actual negotiations between the transaction parties play an important role in the characterization of the transition period payments.

  To the extent that the parties disagree on the purchase/sale price and the transition period payments are later proposed as a means of resolving that sale price disagreement, this factor may indicate that the transition period payments should be characterized as a deferred purchase price.
- Target company price valuation. If the amount of the transition period payments represent a component of the total reasonable value for the acquired company, this factor indicates that the transition period payments should be characterized as deferred purchase price.
- The amount of employee/seller reasonable compensation. If the individual selling shareholders are already being paid a reasonable level of employee compensation for their post-transaction services, then this reasonable compensation factor may indicate that any additional transition period payments should be characterized as deferred purchase price.

When the post-transaction services are tied to the transition period payments, then the payments may be considered as compensation for services under Regulations Section 1.61-2.

However, if one or more of the above-mentioned structuring factors are present, then the parties should consider whether:

1. there is any compensatory intent to the transition payments or
2. the transition payments represent one component of the intrinsic value of the acquired company stock or assets.

From an income tax perspective, some of the judicial and administrative guidance related to these transition period payment characterization questions includes the following:

- *Arrowsmith* (344 U.S. 6 (1952)). In the *Arrowsmith* judicial decision, two taxpayers liquidated a corporation that they had co-owned.

  The two taxpayers divided the corporate liquidation proceeds equally, reporting the profits from the distributions as capital gains. In a subsequent tax year, a judgment was rendered against the liquidated corporation.

  The two taxpayers paid the judgment, and they then reported the judgment payment as an ordinary business loss deduction.

  In this judicial decision, the court held that those judgment payments—and the resulting tax deduction—were capital in nature. The court reached this conclusion because the claim on which the judgment was rendered related to the original corporate liquidation.

  The court concluded that the basis of the taxation treatment related to the origin of the claim (i.e., the liquidation).

  Likewise, if the payment of a transition payment represents nothing more than the intrinsic value of the company stock (or assets) that the individual sellers owned before the transaction, then *Arrowsmith* suggests that the transition payments represent a payment for the acquired company shares (or assets).

- *Lane Processing Trust*, 25 F.3d 662 (8th Cir. 1994). In the *Lane Processing Trust* judicial decision, an employee-owned company sold all of its assets, Then, the company sale proceeds were distributed to the employee-owners.

  In this case, both the right to the distribution and the amount of the distribution were contingent upon the employee/shareholders being employed by the company at the time of the transaction, their job classification, their length of employment, and so forth.

  The court rejected the company's claim that the distribution payments were not employee compensation.

  Rather, the court held that the distribution payments were based on factors "traditionally used to determine employee compensation, specifically, the value of services performed by the employee, the length of the employee's employment, and the employee's prior wages."

  Therefore, the court concluded that the sale proceed payments were more closely aligned to employment services than to stock ownership.

- *R.J. Reynolds Tobacco Co.* (149 F.Supp. 889 (Ct. Cl. 1957)). In this case, an employer company claimed that payments made to certain owner-employees, under a profit distribution plan and proportionate to their shareholdings, were deductible compensation expense—rather than stock dividends.

  The court held that the payments were not compensation payments, but were instead on account of the employees' stock ownership.

  The court reached this conclusion for the following reasons:

  1. The payments were in proportion to each employee's stock ownership.
  2. The payments were in addition to each employee's existing reasonable compensation arrangements.
  3. In prior income tax, accounting, and litigation matters, the employer company had treated the payments as dividends rather than as compensation.

- Revenue Ruling 2007-49. In Revenue Ruling 2007-49, three sets of guidance were issued on the following situations:

  1. No "transfer" for Section 83 purposes had occurred when new services-based restrictions imposed on vested stock caused those same stock shares to become "unvested."

2. A transfer for Section 83 purposes did occur when an employee-shareholder exchanged substantially vested stock for unvested stock in a Section 368(a) reorganization.
3. A transfer for Section 83 purposes also occurred when an employee-shareholder exchanged substantially vested stock for unvested stock in a taxable stock acquisition transaction.

In situation (1), Revenue Ruling 2007-49 suggests that an employee shareholder can subject its existing stock to services-related conditions and retain capital gains tax treatment.

In situations (2) and (3), the employee shareholder will maintain basis in the property and can make a Section 83(b) election at the transfer in order to have any subsequent gain taxed at the capital gains tax rate.

While not directly on point with respect to the transition period payment issue, this ruling suggests that, at the very least:

1. the intrinsic value of the stock is capital in nature and
2. any increase in that stock value may (or may not) require a Section 83(b) election in order to subject any additional upside to capital gains tax treatment.

Summary and Conclusion

Closely held company acquirers often ask the selling employee/shareholders to continue to provide services to the company for a transition period after the company sale is completed.

These company acquirers want to ensure that there is an efficient transition of the sellers' relationships with customers/clients, suppliers and subcontractors, and employees.

The structuring (or the characterization) of these transition period payments can have a direct income tax consequence to both:

1. the company buyer and
2. the selling employee/shareholders.

Such transition period payments may be categorized as compensation expense for services provided by the selling shareholders. These payments would qualify as current period tax deductions for the acquired company, but they would represent ordinary income to the selling employee/shareholders.

"Such transition period payments . . . would qualify as current period tax deductions for the acquired company, but they would represent ordinary income to the selling employee/shareholders."

Alternatively, these transition period payments may be categorized as contingent purchase price earn-out payments.

These payments would represent capital gains to the selling employee/shareholders, but they would only adjust the buyer's tax basis in the acquired company stock or assets.

In other words, the acquired company would not receive an income tax deduction for these payments.

This discussion summarized the transition period payment income tax considerations to both the company buyer and the company sellers. This discussion listed many of the factors that the transaction parties should consider when characterizing these payments.

And, this discussion presented some relevant judicial and administrative tax guidance with regard to the characterization of such payments as compensation expense versus a purchase price earn-out.

The transaction participants should consider this transition period payment characterization issue when negotiating and structuring the company sale transaction. Both transaction parties may consult their tax and legal advisers.

And, both transaction parties may consult a valuation analyst in order to assess:

1. the reasonableness of the post-transaction employee/sellers' compensation and
2. the reasonableness of the total amount of the transaction purchase price.

Robert Reilly is a managing director of the firm and is resident in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

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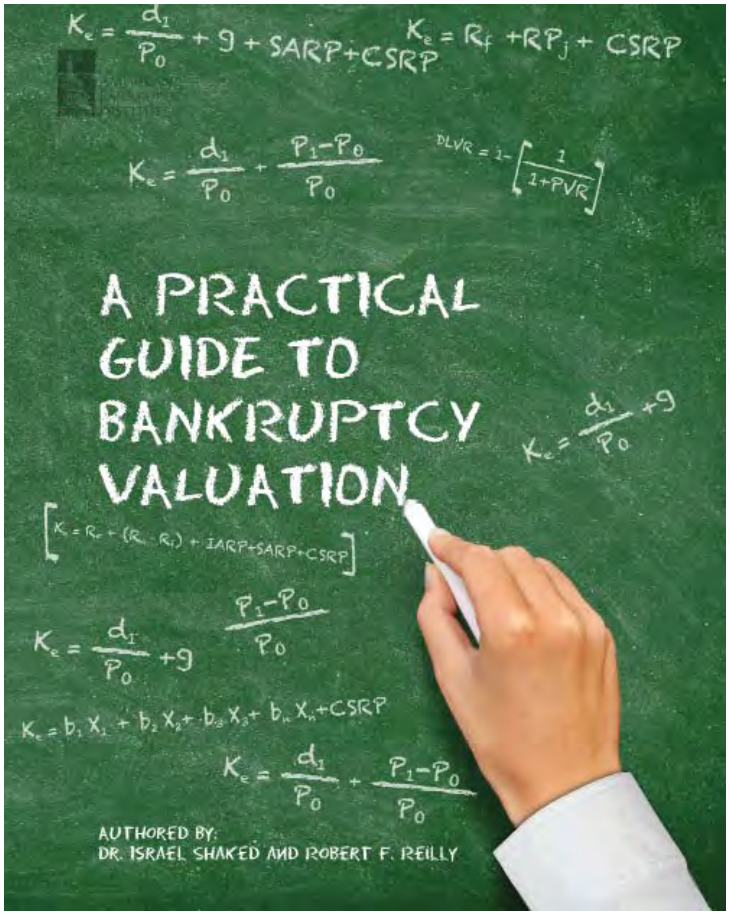

Published by the American Bankruptcy Institute in 2013, *A Practical Guide to Bankruptcy Valuation* contains a wealth of information on how solvency and capital adequacy analyses, debtor-in-possession financing, fraudulent conveyance and preference claims, restructuring of debtor securities, sale of bankruptcy estate assets, plans of reorganization, bankruptcy taxation issues and fresh-start accounting issues, among others, are factored into properly valuing a bankrupt company.

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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Dissenting Shareholder Appraisal Rights and Shareholder Oppression Litigation Matters

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We provided security valuation expert testimony services to Robbins Geller Rudman & Dowd LLP in a dissenting shareholder appraisal rights litigation in the Delaware Court of Chancery

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We provided business valuation and economic damages forensic analysis to Grant & Eisenhofer P.A. in a shareholder oppression litigation claim

We provided business valuation and expert testimony services to King & Spalding LLP in a shareholder oppression litigation claim in the State of Georgia

We provided business valuation and expert testimony forensic analysis to Sidley Austin LLP in a shareholder oppression litigation claim in the State of Illinois

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On Our Web Site

Recent Articles and Presentations

Shawn Fox, a managing director in our Chicago office and the leader of our economic damages analysis practice, co-delivered a presentation along with Michael Conway, litigation partner and national business litigation practice leader at Shook Hardy & Bacon L.L.P. Mr. Fox and Mr. Conway were interviewed by Casey Zgutowicz, vice president at Lockton Companies' Chicago office. The topic of this interview was "Representations & Warranties Insurance—The Claims Expert's Perspective."

Shawn discussed key considerations in calculating economic damages on indemnification claims, accounting disputes for the buyer and seller, and the role of the forensic accountant in merger and acquisition disputes. A link to the video of this presentation can be found on our website.

Robert Reilly, a managing director of our firm, delivered two presentations at the 2015 Forensic and Valuation Services Conference. The conference, which is sponsored by the American Institute of Certified Public Accountants, was held November 9-10, 2015, in Las Vegas. Robert's first topic was "Separating Intangible Assets from Real Property in Real Estate Appraisals." Robert's second topic was "Differences between a Business Valuation and an Intangible Asset Valuation."

Robert's first presentation discussed the identification of intangible assets and various reasons to value these assets. He also explored the generally accepted intangible asset valuation approaches and methods. Robert also discussed various reasons to extract intangible asset value from the overall enterprise value. Illustrative examples were provided for the direct subtraction method, the income allocation method, and the royalty rate method.

Robert's second presentation began with a discussion of the valuation purpose and objective. He then explored various types of analyses and opinions. Robert examined the generally accepted business valuation approaches as well as the generally accepted intangible asset valuation approaches. He discussed the differences in applying the income, market, and cost (or asset-based) approaches for a business valuation and an intangible asset valuation

Robert Reilly, a managing director of our firm, delivered a presentation at the 2015 Advanced Annual Property Tax Seminar. The seminar, which is sponsored by the National Association of Property Tax Representatives—Transportation, Energy, Communications, was held October 27, 2015, in Savannah, Georgia.

Robert's presentation discussed issues related to property tax professional standards. He explored the current property tax issues related to the transportation, energy, and communications industries. And, Robert discussed recent and pending changes to the Uniform Standards of Professional Appraisal Practice.

Robert F. Reilly, firm managing director, and Aaron M. Rotkowski, vice president and leader of our property tax valuation practice, published an article in the Fall 2015 issue of *The Practical Tax Lawyer*, a quarterly professional journal. The title of their article was "Valuation of Taxpayer Companies with NOL Carryforwards."

Robert and Aaron describe how to consider net operating losses—and the associated NOL tax attributes—in valuations performed for property tax purposes. Their article defines an NOL carryforward and an NOL carryback and explores whether an NOL carryforward should be categorized as tangible property. It then analyzes the use of the 0 percent tax rate assumption in a valuation intended to conclude a market value estimate. It considers applying an after-tax capitalization rate to a pretax income stream. Finally, the article summarizes the factors that affect the market value of an NOL carryforward.

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the July 2015 issue of *FVS Consulting Digest*. The title of Robert's article was "Valuation of the License or Permit Intangible Asset."

Robert Reilly also authored an article that appeared in the September 2015 issue of *Transaction Advisors*. The title of Robert's article was "Structuring Transition Period Payments in Closely Held Company Acquisitions."

Robert Reilly also authored an article that appeared in the September/October 2015 issue of *Construction Accounting and Taxation*. The title of Robert's article was "When You Need an Intellectual Property Valuation."

Robert Reilly also authored an article that appeared in the October 2015 issue of the *ABI Journal*. The title of Robert's article was "Technology Intangible Assets."

Robert Reilly also authored an article that appeared in the November/December 2015 issue of *Valuation Strategies*. The title of Robert's article was "Measuring Damages to Intangible Assets."

Robert Reilly also authored an article that appeared in the Fourth Quarter 2015 issue of *Transaction Advisors*. The title of Robert's article was "Structuring Transition Period Payments in Closely Held Company Acquisitions."

Robert Reilly and Aaron Rotkowski, Portland office vice president, authored an article that appeared in the Fall 2015 issue of *The Practical Tax Lawyer*. The title of their article was "Valuation of Taxpayer Companies with NOL Carryforwards."

Robert Reilly also authored an article that appeared in the September 17, 2015, online publication *QuickRead* by the National Association of Certified Valuators and Analysts (NACVA). The title of Robert's article was "Treatment of Selling/Employee Shareholder." It can be found at quickreadbuzz.com.

Lisa Tran, vice president, and Irina Vrublevskaya, manager, both of our Portland, Oregon, office, authored an article that appeared in the October 21, 2015, online publication *QuickRead*. The title of their article was "Dissenting Shareholder Appraisal Rights and Shareholder Oppression Claims: Similarities and Differences in Securities Valuation."

Christopher Silvetti, Chicago office associate, also authored an article that was published in the September 24, 2015, issue of NACVA's *QuickRead*. The title of Christopher's article was "Estate of Giustina v. Commissioner." It can also be found at quickreadbuzz.com.

Samuel Nicholls, Atlanta office manager, authored an article that appeared in the October 2015 issue of *FVS Consulting Digest*. The title of Sam's article was "A Review of BMC Software, Inc. v. Commissioner of Internal Revenue: Should Intercompany Accounts Receivable Be Considered 'Debt'?"

In Person

Curtis Kimball, Atlanta office managing director, delivered a presentation on June 25, 2015, to the Shreveport Tax & Estate Planning Council Conference. The topic of Curt's presentation was "Valuation Topics 2015."

Curt Kimball also delivered a presentation at the American Bar Association's Skills Training for Estate Planners Program at New York Law School on July 16, 2015. The topic of Curt's presentation was "Valuation Theory and Practice: Selecting and Working with Appraisers."

Curt Kimball also delivered a presentation at the National Trust Closely Held Business Association conference on September 14, 2015, in New Orleans. The topic of Curt's presentation was "IRS Job Aids on Closely Held Entity Issues: An Update."

Shawn Fox, Chicago office managing director, was interviewed by Casey Zgutowicz of Lockton Companies on the subject of current trends involving representations and warranties insurance. In particular, Shawn discussed key considerations in calculating economic damages on indemnification claims and the role of the forensic accountant in merger and acquisition disputes. This interview will be posted on www.lockton.com.

In Encomium

Kevin Zanni, Chicago office director, was elected to serve on the board of directors of the Business Valuation Association of Chicago.

Insights Archives

❑ Autumn 2015

Focus on Dissenting Shareholder Appraisal Rights and Shareholder Oppression Litigation

❑ Autumn 2014

Focus on Gift, Estate, and Generation-Skipping Tax Issues

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