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Insights

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Business Valuation, Forensic Analysis, and Financial Opinion Insights

Best Practices

Willamette Management Associates

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Insights

Insights, the thought leadership journal of applied microeconomics, is published on a quarterly basis, with periodic special interest issues. *Insights* is distributed to the friends and clients of Willamette Management Associates, a Citizens company.

Insights is intended to provide a thought leadership forum for issues related to the Willamette Management Associates business valuation, forensic analysis, and financial opinion services.

Insights is not intended to provide legal, accounting, or taxation advice. Appropriate professional advisers should be consulted with regard to such matters. Due to the wide range of the topics presented herein, the *Insights* thought leadership discussions are intended to be general in nature. These discussions are not intended to address the specific facts and circumstances of any particular client situation.

The views and opinions presented in *Insights* are those of the individual authors. They are not necessarily the positions of Willamette Management Associates or its employees.

This is our final issue of *Insights*. In April we will be launching a new digital publication called *Perspectives*. If you would like to be added to the list to receive *Perspectives*, please scan this QR code and enter your contact information. If you prefer, you can go directly to this site and enter your contact information: https://willamette.com/perspectives-sign-up

Insights Editors and Staff

Robert Schweihs
Managing Editor
rpschweihs@willamette.com

Charlene Blalock
Editor
cmblalock@willamette.com

Mary McCallister
Production Editor
mmccallister@willamette.com

Mark Abbey
Business Manager
mfabbey@willamette.com

Debi Quinlivan
Accountant
dlquinlivan@willamette.com

Michael Amoroso
Financial Analyst
mcamoroso@willamette.com

Editorial Board

Willamette Management Associates

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Editor for This Issue: Robert F. Reilly, CPA

Forethoughts

Due to the high costs of production and distribution and the changes in reader preferences to online publications, many professional journals have discontinued print publication in recent years. For these and other reasons, our firm's senior management has decided to discontinue the publication of *Insights*. After 32 years and 135 issues, this issue will be the final publication of our firm's quarterly journal.

Insights has always presented the best practices with regard to valuation analyses, damages measurements, and transfer price analyses. Therefore, this final *Insights* issue is simply titled "Best Practices." To represent the Willamette Management Associates broad menu of professional services, this final issue presents a potpourri of thought leadership discussions.

The first discussion relates to the valuation of S corporation companies and securities. This discussion recommends that valuation analysts (and other professional advisers) consider both the cons as well as the pros of the S corporation income tax status.

The second discussion relates to economic damages measurements. This discussion recommends that damages analysts (and litigants and counsel) consider the income tax liability created by the judicial award in the damages measurement.

The third discussion relates to the appraisal of special-purpose industrial and commercial property for state and local property tax purposes. This discussion presents best practices related to economic obsolescence measurements.

The fourth discussion relates to best practices for developing fair value measurements for U.S. GAAP accounting compliance purposes.

The fifth discussion relates to selecting economic variables for valuation, damages, or transfer price analyses.

The final discussion considers best practices for reasonableness of executive compensation analyses.

For nearly 55 years, Willamette Management Associates has provided thought leadership to our clients and best practices to the professions in which we practice. We will continue to provide thought leadership in a new digital publication we plan to call *Perspectives*. *Perspectives* will be published periodically to inform our clients and colleagues on, well, our perspective.

We hope you benefit from this final *Insights* issue. And, we hope you sign up to receive our firm's new publication *Perspectives*.

About the Editor

Robert F. Reilly

For over 46 years, Robert's practice has included valuation analysis, damages measurement, and transfer price analysis services. Robert has served as a managing director of our firm for over 32 years.

During his career, Robert has served clients with regard to transaction, taxation, financing, financial accounting, controversy, and corporate planning issues. In addition to serving as a consulting expert, Robert has served as a testifying expert on over 200 occasions. In these instances, Robert has testified in federal and state courts and tribunals and in international courts and tribunals.

Robert has co-authored 12 books and authored more than 1,000 journal articles related to the valuation, damages, and transfer price technical disciplines. Many of these publications have received "book of the year" and "article of the year" recognitions from various professional organizations.

Over the years, Robert has presented at several hundred valuation, forensic accounting, and taxation conferences—both domestically and internationally.

Robert is proud of his volunteer service to various professional organizations. He has served as committee chair, conference chair, course developer, journal editor, and author for such professional organizations as the American Institute of Certified Public Accountants, the American Bankruptcy Institute, and the National Association of Certified Valuators and Analysts.

After contributing over 200 thought leadership articles to *Insights* over the last 32 years, we are pleased to have Robert serve as the editor for this final *Insights* issue.

Perspectives

After 32 years of publication, this is the final issue of our quarterly print journal *Insights*. We are excited to announce the creation of a new firm publication, *Perspectives*. *Perspectives* will be an online thought leadership journal, published periodically and available by email and on our firm's website.

Introduction

Willamette Management Associates has decided to discontinue the print publication of our quarterly journal *Insights*. After 32 years of publications and 135 issues, this is the last *Insights* issue.

Reader preferences have shifted from print publications to digital publications. The firm's decision to discontinue the print publication of our thought leadership journal recognizes this trend in professional readership preferences.

Appreciation

We want to express our sincere appreciation to our *Insights* subscribers, readers, and friends over the years. We hope that you have benefitted from the thought leadership discussions *Insights* has presented on a range of valuation analysis, damages measurement, and transfer price determination topics.

Prominence and Eminence

Insights has earned numerous awards and recognitions over the years, both domestically and internationally. Those recognitions are due entirely to the dedication and professionalism of our authors, editors, and production staff.

We appreciate the contributions of the hundreds of *Insights* authors over the past 32 years. In addition, we appreciate the contributions of our 135 issue editors over that 32-year period.

Finally, we appreciate the tireless efforts of our production staff. All of the individuals listed in the *Insights* masthead contributed to this effort. However, two individuals are primarily responsible for the *Insights* prominence and eminence: production editors Mary McCallister and Charlene Blalock. Mary and Charlene should be proud of their contribution to the thought leadership of our profession.

Perspectives

Available by email and on our firm's website, *Perspectives* will be published periodically. *Perspectives* will present thought leadership discussions on timely topics related to our firm's professional services.

We hope our clients and friends—as well as our colleagues in the profession—will continue to benefit from the thought leadership discussions presented in this new digital format.

Summary and Conclusion

We recognize and thank all of our readers, friends, authors, editors, and production staff for your support of *Insights* for over three decades. We hope you continue to support—and to benefit from—our new professional publication *Perspectives*.

If you wish to receive our new publication *Perspectives* by email, we need to here from you and receive your email address. Please scan the code below to enter your information. The emails will be sent out approximately quarterly.

Thought Leadership Discussion

Consideration of Negative Influences on S Corporation Values in Transfer Tax Business Valuations

Robert F. Reilly, CPA

The valuation of an S corporation ownership interest is a typical assignment in the transfer tax context. In such equity interest analyses, valuation analysts ("analysts") typically recognize the economic benefits of the S corporation's tax pass-through entity ("TPE") status—compared to that of a C corporation's income tax status. Analysts have developed a variety of procedures to quantify the value impact (typically the value increment) associated with the S corporation's TPE status. Many of these procedures involve the following three-step process: (1) value the subject entity as if it were a C corporation, (2) separately measure some (or all) of the income tax benefits related to the subject entity's S corporation tax status, and (3) sum the two value components in order to conclude the total value of the subject S corporation ownership interest. However, analysts sometimes neglect to account for the fact that there are negative influences—as well as positive influences—associated with an entity's S corporation income tax status. Such negative influences include restrictions on the number of and type of company shareholders, limitations on the current shareholders' ownership exit opportunities, inadvertent disqualification events related to the S corporation status, special tax situations upon the death of the S corporation shareholders, state income tax requirements for S corporations, and other issues that may negatively impact the value of an S corporation ownership interest. In business and security valuations developed for transfer tax (and other) purposes, analysts should be aware of—and should intentionally consider—the "cons" as well as the "pros" associated with the subject entity's S corporation income tax status.

Introduction

Valuation analysts ("analysts") are routinely asked to develop a valuation of an ownership interest in an S corporation for gift tax, estate tax, generation-skipping transfer tax, and other transfer tax purposes. In addition, analysts may also be asked to value the stock of an S corporation for income tax, financial accounting, personal financial planning, transaction pricing and structuring, financing collateral, family law and other litigation matters, and many other purposes.

For many other client purposes, analysts may also be asked to value an ownership interest in a limited liability company, partnership, or some other form of tax pass-through entity ("TPE").

In these valuation assignments, it is important for analysts (and other professional advisers) to understand that there are material taxation (and, therefore, economic) differences between:

1. an S corporation and
2. an otherwise identical C corporation.

It is also important for analysts (and other professional advisers) to understand that there are material taxation (and, therefore, economic) differences between (1) an S corporation and (2) other types of TPE.

For an industrial or commercial business entity, and for a professional practice or professional services firm, there are obvious federal income taxation benefits associated with electing S corporation status. These benefits typically result in a value increment or increase for the S corporation—compared to the value of an otherwise identical C corporation.

This discussion begins with a summary of these well-known economic benefits of S corporation income tax status.

Over the years, analysts have developed various methods and procedures for quantifying the value increment associated with a subject company's S corporation tax status.

Generally, most of these valuation methods and procedures apply a three-step process. That three-step process is summarized as follows:

1. Apply generally accepted approaches and methods to value the subject entity as if it were a regular C corporation
2. Identify and quantify the income tax (and other) economic benefits associated with the subject entity's TPE status
3. Sum value component one (as if the subject entity were a C corporation value) and value component two (sometimes called the S corporation value premium) in order to conclude the total value of the subject entity

There are also somewhat less obvious negative aspects related to an industrial or commercial business entity electing S corporation status. These negative aspects include restrictions on the number and the type of S corporation shareholders.

Such restrictions may negatively affect the liquidity of individual S corporation ownership interests. And, such restrictions may negatively affect the ownership transition and exit planning strategies available to a family-owned S corporation.

There are special tax considerations related to the transfer of S corporation stock at the time of the owner's death. And, owners of S corporation stock have to be intentional with regard to the risks (and the tax costs) associated with an inadvertent termination of the subject entity's S corporation status.

S corporation owners—and analysts—should also be aware that many states tax S corporations for state corporation income tax purposes. Many states tax S corporations as if they were C corporations. And, many other states apply a special corporate income tax rate to S corporations.

The point of this discussion is that there are both positive and negative influences on the value of an S corporation business entity.

This discussion will not recommend analyst procedures related to the measurement of the S corporation status value premium. Likewise, this discussion will not recommend analyst procedures related to the measurement of the discount for lack of marketability ("DLOM") or any other value decrements related to an entity's S corporation tax status.

Such recommendations are beyond the scope of this discussion. And, these procedural topics have been thoroughly addressed in the valuation professional literature.

Analysts are quick to identify and quantify the implicit and explicit S status economic benefits in the S corporation business valuation.

The objective of this discussion is to summarize the offsetting economic risks associated with an S corporation ownership interest. Analysts should be equally conscious of the risks—as well as the benefits—of S corporation status in the valuation of a private company or professional practice.

This discussion summarizes many of these risk factors that analysts, stockholders, estate planners, and tax counsel should consider in the valuation of an S corporation ownership interest for transfer tax purposes.

Summary of S Corporation Benefits

The economic benefits of electing S corporation federal income tax status are generally well known. An S corporation is sometimes referred to as a hybrid-type of business organization, between a C corporation and a partnership.

S corporation tax status avoids the double taxation disadvantage associated with the typical privately owned C corporation. In an S corporation, all entity-level income, losses, deductions, and certain credits pass through to the company or practice shareholders. That is why an S corporation is frequently referred to as a TPE.

For federal tax purposes, all of the entity's income is taxed once, at the shareholder level. (Again, some states may tax S corporation income at the entity level.)

Not having to pay federal income taxes at the entity level is the principal benefit of the S corporation election. This particular economic benefit may be most valuable in the early years of an entity's business life.

This benefit may be particularly important because the start-up or early-stage entity may have limited

liquidity. The cash that would otherwise go to C corporation income tax payments could be used to find growth-related operating expenses, working capital investments, or capital expenditures.

It is noteworthy that S corporations are exempt from federal income taxes on most—but not all—income. For example, certain capital gains and passive income are subject to federal taxation at the S corporation level.

In addition, the S corporation tax status may reduce the total income tax liability of the privately company or professional practice stockholders.

By characterizing the cash distributions from the company as either salary payments or dividends/distributions, the shareholder/employees may be able to reduce their self-employment taxes. The S corporation is allowed to deduct business expenses and reasonable salaries paid to employees (including shareholder/employees).

S corporation shareholders can be company/practice employees. Such employee/shareholders can earn salaries that are deductible by the company practice.

In addition, such employee/shareholders can also receive distributions of the company profits on a tax-free basis—as long as the distributions do not exceed the shareholder's stock basis.

If the distributions do exceed the shareholder's stock basis, then the excess may be taxed as capital gains (i.e., at a lower tax rate than would apply to ordinary income).

Outside of the taxation area, incorporation may provide credibility to a start-up, early-stage, or other privately owned company or professional practice—compared to either sole proprietorship or partnership status. That is, potential customers, suppliers, landlords, employees, bankers, and others may find a corporation entity to be more credible—compared to a similar sized partnership or proprietorship.

Like any other corporation, an S corporation provides certain legal liability protections to the company or practice owners—compared to the proprietorship or partnership form of business organization. For example, S corporation status (and limited liability company—or LLC—status) provide the assets of the business owners with certain protection from business creditors.

In addition, the S corporation (and the LLC) business owners generally cannot be held personally responsible in lawsuits filed against the company or practice.

Risks Associated with the S Corporation Income Tax Status

S corporation status is created under Subchapter S of the Internal Revenue Code. An S corporation is defined in Internal Revenue Code Section 1361.

To achieve S corporation income tax status, the entity has to file Form 2553, Election by a Small Business Corporation. The Form 2553 has to be signed by all of the company shareholders.

The Form 2553 should be filed with the Internal Revenue Service (the "Service"):

1. within 75 days of the company's initial incorporation or
2. within 75 days after the beginning of each tax year.

The Service may accept the filing of an S election after the 75-day period has passed, but the Service is not required to do so.

Valuation analysts, private company owners, estate planners, and tax counsel are generally familiar with the economic benefits associated with S corporation tax status. The most significant of these economic benefits were summarized above. In particular, the taxation-related benefits of S corporation status are well known.

Analysts have developed numerous methods and procedures to incorporate the value increment—or value premium—associated with this tax status election into the valuation of S corporation ownership interests. These methods and procedures are generally described in the professional valuation literature and will not be repeated here.

As with most federal taxation elections, there are risks as well as benefits associated with the S corporation income tax status. Both private company and professional practice owners should consider these risks when making investment, transaction, financing, taxation, and even litigation decisions.

Estate planners should consider these risks when making and implementing estate planning recommendations to owners of private businesses and professional practices.

Tax counsel should consider these risks with regard to all planning, compliance, and controversy decisions related to the client's private company or professional practice.

And, valuation analysts should consider these risks in the valuation of the S corporation business entity and S corporation securities.

Analysts may consider that such risks may have a decremental impact or negative influence on the subject entity's value. Analysts may consider if that impact or influence may partially offset or mitigate the incremental value—or the value premium—associated with the subject entity's S corporation status.

These analyst considerations are the primary focus of this discussion.

Some of the risks associated with an S corporation ownership interest are summarized below. Analysts should be aware of these risks—and their associated value influences—when developing and reporting the S corporation valuation analysis.

A description of how (procedurally) the analyst incorporates these risk considerations is beyond the scope of this discussion.

Some analysts have considered incorporating these risk factors into one or more of the following business and security valuation variables:

1. The development and final selection of the present value discount rate or the direct capitalization rate in the application of the business valuation income approach
2. The assessment, adjustment, and final selection of valuation pricing multiples (whether capital-market-derived or transaction-derived) in the application of the business valuation market approach
3. The identification and measurement of goodwill (or of the recognition of some type of deferred tax liability) in the application of the business valuation asset-based approach
4. The recognition in the valuation synthesis and conclusion process of (a) some increment in the assessment and measurement of an entity level value adjustment for illiquidity or (b) a security level value adjustment for lack of marketability
5. Other adjustments to (a) the valuation variables applied or (b) the value indications concluded

The only best practice recommended by this discussion is that the analyst (and the business owner, the estate planner, the tax counsel, and any other professional adviser) should consider both the following risks (economic disadvantages) as well as the above-described benefits (economic advantages) in any analysis of the S corporation.

Restrictions on the Number and Type of S Corporation Shareholders

Internal Revenue Code Section 1361 provides the limitations and restrictions with regard to S corporation shareholders. A company or practice elects to become an S corporation under the provisions of Section 1362.

The most common of the Section 1361 limitations and restrictions are listed below:

1. The company or practice has to be a domestic corporation or other entity.
2. The company or practice may have no more than 100 shareholders at any one time. (An individual and his or her spouse are considered to be one shareholder.)
3. Each of the S corporation shareholders has to be an individual, estate, trust, tax-exempt organization, or another S corporation (a C corporation or a partnership cannot be an S corporation shareholder).
4. The company or practice may not have a nonresident alien as a shareholder.
5. The corporation may only have one class of stock. All of the company or practice stock should have the same rights with regard to profit distributions and liquidation distributions.
6. The company or practice may not be an ineligible corporation, including a financial institution, an insurance company, or a domestic instruction sales corporation ("DISC").
7. The company or practice has to have to adopt either a December 31 tax year-end (the most common) or a natural business year-end, an ownership tax year, or a 52- or 53-week tax year.
8. The company or practice has the consent of each of the shareholders. (If two spouses have a community interest in the S corporation stock, then both spouses need to consent.)

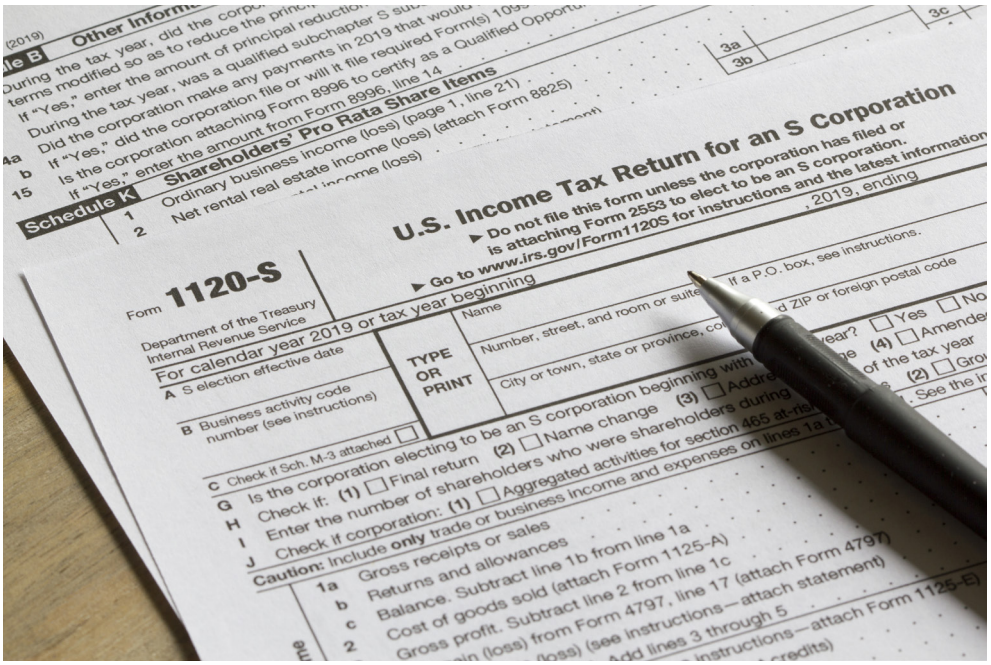
First, to be an S corporation, the business has to be a corporation or entity based in the United States.

Second, the company or practice may have no more than 100 shareholders at any one time. Shareholders may buy and sell the S corporation stock during the year. So, in total, the company may have more than 100 recorded shareholders throughout the year. But, the company may not have more than 100 shareholders at any one point in time.

Members of a family may be treated as one shareholder. A husband and wife (the terms used in Section 1361(c)(1)(A)(i)) and their estates are treated as one shareholder. Also, all members of a family (and their estates) are treated as one shareholder.

Section 1361(c)(1)(B)(i) states: "The term 'members of a family' mans a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant."

Third, the Internal Revenue Code prohibits most types of entity from being shareholders of an S corporation. Even individuals have to meet the qualifications to be shareholders of an S corporation.



To be an S corporation shareholder, an individual has to meet one of the following two qualifications:

1. Be a U.S. citizen
2. Be a permanent resident of the United States.

So, individuals who are not U.S. citizens or U.S. residents cannot be shareholders in an S corporation.

Fourth, the following types of taxpayers are not allowed to own stock in an S corporation:

1. A C corporation
2. A partnership
3. A nonresident alien
4. A foreign trust
5. A multiple-member limited liability company
6. A limited liability partnership
7. An individual retirement account ("IRA")

Fifth, Section 1361(b)(1)(D) clearly indicates that an S corporation may not have more than one class of stock.

However, Section 1361(c)(4) provides for differences in common stock voting rights as follows: "For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock."

Sixth, an "ineligible corporation" cannot be an S corporation shareholder. The term "ineligible corporation" is defined in Section 1361(b)(2) as follows:

> For purposes of paragraph (1), the term "ineligible corporation" means any corporation which is—
>
> (A) a financial institution which uses the reserve method of accounting for bad debts described in Section 585,
>
> (B) an insurance company subject to tax under subchapter 2, or
>
> (C) a DISC or former DISC.

Seventh, there are several requirements related to the selection of the S corporation's tax year.

To be an S corporation, the business has to change to or adopt one of the following tax years:

1. The calendar year ending December 31
2. A period of 12 consecutive months that ends during a low period of business activities
3. An ownership tax year
4. A tax year selected pursuant to Section 444
5. A 52- or 53-week tax year, as long as the company's fiscal year is maintained on the same basis
6. Any other tax year for which the company demonstrates a valid business purpose

Eighth, Section 1362 describes the shareholder election requirements related to an S corporation.

Section 1362(a)(2) states that all shareholders have to consent to the S election, as follows: "An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day in which such election is made consent to such election."

Given the above-listed restrictions, then, who can be an S corporation shareholder? With respect to individual shareholders, we know that any U.S. citizen or U.S. permanent resident can be an S corporation shareholder. However, many types of entities are prohibited from being the owner of an S corporation.

The types of entities that are permitted to be S corporation shareholders fall into three general categories:

1. Single-member businesses
2. Estates of recently deceased S corporation shareholders
3. Bankruptcy estates of S corporation shareholders who have recently filed for bankruptcy

In many of the above-noted instances, the entity is allowed to hold the S corporation stock on a temporary

basis only. That is, the Internal Revenue Code allows such temporary ownership in order to prevent the collapse of the S corporation due to the bankruptcy or the death of the S corporation shareholder.

In addition to the above types of entities, the following list includes some of the entities that can be an S corporation shareholder:

1. Single-member S corporations, the owners of which are U.S. citizens or U.S. permanent resident
2. Certain S corporations called Qualified Subchapter S Corporations
3. Grantor trusts (also known as living trusts)
4. Some testamentary trusts
5. Some tax-exempt organizations (including not-for-profit entities)
6. Some voting trusts
7. Some irrevocable trusts

Accordingly, there are a number of types of individuals and types of entities that may own S corporation stock. This discussion is not intended to imply that there is no liquidity related to the S corporation or the S corporation shares.

That said, when measuring the impact of liquidity (or the lack thereof) on the value of the S corporation business entity or the S corporation shares, the analyst should consider that the following types of individuals and entities may not own S corporation stock: all foreign individuals (who are not permanent U.S. residents), all partnerships, all C corporations, all multi-member limited liability companies, all limited liability partnerships, all business trusts, all foreign trusts, and all IRAs.

Considerations with Regard to S Corporation Liquidity

Ignoring the investment risks associated with S corporation disqualification (discussed below) and other risk factors, the analyst should appreciate that S corporation stock is generally less liquid than identical C corporation stock.

Let's assume that the subject S corporation has the same owner legal protections and the same other legal benefits as the hypothetical comparable C corporation.

Let's assume that the subject S corporation has the same entity size, expected growth rate, profit margin, return on investment, and other financial and operational attributes as the comparable C corporation.

The fact is, there are simply fewer market participants available that would qualify to be a willing buyer to transact with the S corporation current owner/willing seller.

There is a smaller pool of willing buyers who could own (and, therefore, who could buy) the S corporation stock—compared to the otherwise identical C corporation stock. The analyst should consider this more limited population of potential market participants somewhere and somehow in the valuation analysis.

The analyst may incorporate these considerations in the individual valuation analyses. That is, the analyst may account for these considerations within the valuation approaches and methods developed within the analysis.

Or, the analyst may incorporate these considerations as a component of a discount for lack of marketability ("DLOM") or other type of valuation adjustment when reconciling various value indications into a final value conclusion.

These considerations should be accounted for in valuations developed for transfer tax purposes—as well as for other purposes. In addition, these considerations have practical implications for S corporation transaction pricing and structuring purposes.

That is, the limitations and restrictions regarding the number and type of S corporation shareholders may directly affect the exit strategies available to the S corporation owners seeking an ownership transition.

Impact of Limitations on S Corporation Exit Strategies

Most owners of either private companies or professional practices have to someday plan for an ownership transition. This statement applies to most family-owned businesses. And, this statement generally applies to most private companies or professional practices, whether or not they are closely held by family members.

The current company or practice manager/owners eventually want to retire. And, eventually, all manager/owners face the inevitable end of life.

Many owners of successful private companies or professional practices consider an initial public offering of the company stock as a potential exit strategy.

Other owners may consider the sale of the company or the practice to a strategic competitor, a sale to a private equity sponsor, a sale through a roll-up transaction involving several companies, a sale to the company's nonowner management team, or a sale to the general employees through an employee stock ownership plan ("ESOP") or other structure.

"Typically, an ESOP can own an S corporation. However, many ESOP acquisitions involve multiple classes of equity."

Even those business owners who are planning to "keep the company in the family" are de facto considering an ownership transition transaction. Such an ownership transfer to the next generation could be accomplished by sale, gift, or bequest.

Implicitly or explicitly, analysts incorporate exit strategies (whether well-developed or amorphous) into their business valuation analyses. All generally accepted business valuation approaches and methods incorporate some type of residual value, reversionary value, or terminal value.

Such value components may be implicit in the analysis. But even the assumption that the subject company or practice will generate income forever implicitly assumes that, at some point, there will be a new owner to enjoy the benefit of that expected future income.

However, if the subject company or practice wants to retain its S corporation status, several typical ownership transition or exit strategies may not be available to it. For example, the S corporation cannot be a publicly traded company. Some private equity or other types of investors may not be interested in buying the S corporation (unless it converts to a C corporation first).

The same reluctance to purchase may be the case with a large C corporation strategic acquirer (whether it is public or private). The C corporation buyer cannot be an S corporation shareholder.

Other exit options may be available, but these options may be limited with respect to their implementation or structure.

Typically, an ESOP can own an S corporation. However, many ESOP acquisitions involve multiple classes of equity.

The company or practice employees may buy one class of stock through the ESOP trust. The company management may buy a different class of stock. Certain founding family members may retain a different class of stock—at least for a period of time.

However, such a more complex (but typical for an ESOP acquisition) capital structure would violate the one class of common stock restriction for the subject S corporation.

Again, one way or the other, the analyst may have to accommodate these exit strategy restrictions in the S corporation business valuation. And, the current business owners, the estate planners, and the tax counsel should consider these restrictions in their estate planning and/or wealth transfer deliberations.

The Inadvertent Disqualification of S Corporation Status

Most of the S corporation disqualification events relate to the limitations and restrictions summarized above. If the subject S corporation fails to maintain its status as a "small business corporation" under Section 1361(b), the S election automatically terminates on the date that the disqualifying event occurs.

Section 1361(b)(1) and Section 1362(d)(2) can be considered together to develop a list of disqualifying events that could unexpectedly terminate the company's S corporation status.

As explained further below, this risk of a disqualifying event can affect both the company itself and the company shareholders.

The most common of the S corporation disqualifying events include the following:

1. The company or practice has more than 100 shareholders at any time during the year. This event could happen to a company with a fairly large number of shareholders, particularly when shareholders are "coming and going" at various times during the year.

2. The company or practice has an ineligible shareholder. This event could happen when one of the current qualifying shareholders transfers the stock to a C corporation, partnership, ineligible trust, or nonresident alien.

   This event could happen, for instance, when a current qualifying shareholder experiences a divorce. The S corporation shares are allocated between the former spouses. A former spouse moves to Canada (or any other country) and remarries. Now, there may be a nonresident alien shareholder that the S corporation is totally unaware of.

3. The company or practice has more than one class of stock. Initially, this disqualification is easy to prevent. However, after many years of business operations, it is possible to forget this (and other) requirements.

   The disqualification event may be inadvertently triggered when one group of employee/shareholders—or one group of family/shareholders—receive some special profit sharing or similar consideration.

4. The company or practice becomes an "ineligible corporation." For example, the subject company becomes a financial institution, an insurance company, or a DISC. This type of disqualifying conversion (or acquisition) should be relatively easy to spot—and to prevent.
5. The company or practice changes it place of incorporation to a foreign country (and no longer qualifies as a domestic corporation). Such a change of incorporation should be easy to spot—unless this S corporation requirement is simply overlooked.

Section 1362 provides all of the specific events that can cause a corporation to fail to qualify as a small business corporation. Filing the corporation's tax return based on an improper tax year is not a Section 1362 disqualifying event, and such a filing may be forgiven by the Service (if corrected).

The S corporation should be careful not to trigger a disqualification if it dissolves and reincorporates, for whatever reason. However, the Service has issued private letter rulings allowing a corporation to keep its S corporation status when it was administratively dissolved by its state of incorporation. In these instances, the subject companies failed to file annual reports and pay annual license fees to the respective states.

In another private letter ruling, a state administratively dissolved an S corporation. The state later reinstated the corporation, and the company obtained a new employer identification number ("EIN").

The Service ruled that the administrative dissolution did not disqualify the S corporation status. However, because of the new EIN, the Service did make the corporation file a new Form 2553 Election by a Small Business Corporation.

The above-listed S corporation disqualifying events, while typical, are pretty easy to identify—and to prevent.

Some other S corporation disqualifying events are more rare, but they are also easy to miss. Some examples include the following events:

1. Say the successor beneficiary of a qualified subchapter S trust ("QSST") refuses to consent to the original QSST election. Such a refusal would mean that the QSST is no longer a qualifying S corporation shareholder—and the S election is disqualified.
2. Say the subject S corporation stock is pledged as collateral for a shareholder's personal loan. The shareholder defaults on the loan. The S corporation stock collateral is foreclosed by the financial institution creditor. That financial institution is an ineligible shareholder—and the S election is disqualified.
3. Say the subject S corporation has accumulated earnings and profits ("AE&P") and receives more than 25 percent of its gross receipts from passive income for three years in a row. That passive income will disqualify the S election.
4. Say an S corporation shareholder dies, and the shareholder's estate holds on to the shares for more than two years. The estate's prolonged stock ownership will disqualify the S election.

Analysts (and other professionals) should be aware that the U.S. Tax Court has ruled that Section 1362(d) does not provide an exhaustive list of all of the S corporation disqualifying events.

For example, the *Farmers Gin* decision[1] relates to an S corporation that inadvertently terminated its S election. In the *Farmers Gin* decision, the company did not adopt a permitted tax year after business conditions changed so that its previously permitted tax year was no longer allowable.

The point is, as mentioned above, the use of an unpermitted tax year is not a disqualifying event that is specified in Section 1362.

Events, obvious or otherwise, that can cause an inadvertent disqualification of a company's S election represents a risk associated with S corporation ownership. In fact, such an inadvertent S status disqualification represents a risk both to the S corporation and to the company's shareholders.

As with any other business risk, the analyst should consider this risk of inadvertent S election disqualification in the S corporation business valuation.

If the company or practice deliberately or unintentionally experiences an S election disqualifying event, the Service can withdraw the company's S corporation status. In some cases, the Service may require the company or professional practice to pay back taxes, at the C corporation income tax rate, for the three years prior to the S status revocation.

In addition, such a company or practice would have to wait another five years to reapply for S corporation income tax status.

Considerations when the S Corporation Shareholder Dies

The death of an S corporation shareholder can create tax complications for the TPE. One of the complications—and one of the risks of S corporation stock ownership—is an inadvertent termination of the company's S corporation status.

There may also be tax complications related to the decedent shareholder's estate. Many of the more typical complications are summarized below.

Analysts—and S corporation shareholders—should consider the impact of these potential tax complications on the value of the subject S corporation ownership interest.

Reporting S Corporation Income and Loss in the Year of Death

In an S corporation, a shareholder's pro rata share of the company's income and loss is typically determined by allocating equal portions to each day of the year. Then, the company allocates income and loss to each shareholder based on the number of shares outstanding on each day.

This income and loss allocation procedure is described in Section 1377(a)(1).

In the year when the shareholder's S corporation ownership interest terminates, such as upon the shareholder's death, the S corporation can elect (under Section 1377(a)(2) and Regulations Section 1.1377-1(b)) to implement an interim closing of the company's books.

That is, the TPE company or practice can elect to treat the S corporation's tax year as two separate tax years for income allocation purposes. All affected company or practice shareholders and the S corporation itself have to consent to this election.

Such a separate tax year election may or may not benefit the S corporation shareholders. Due to accounting and tax return preparation fees, the interim closing of the company books may be costly to complete. But making the election may be beneficial, particularly in situations where extraordinary items occur either before or after the shareholder's death.

For example, let's assume the subject S corporation generates a large gain predeath. In that case, the ultimate beneficiaries of the shares may prefer that the decedent pay his or her full share of tax on that item in contrast to burdening the beneficiaries with a portion of the gain (and the related tax).

If the decedent's estate is subject to estate tax, then the payment of tax on the S corporation gain reported on the decedent's final income tax return will reduce the estate tax liability.

When such a situation occurs, the decedent's beneficiaries—and the company itself—will have to carefully analyze the pros and cons of this tax election.

The Inadvertent Termination of the S Election

The failure of the corporation and the successor shareholders to consider all of the implications to the corporation's S tax status after a shareholder's death is a typical cause of the inadvertent termination.

In many cases, the successor shareholder, whether that shareholder be the estate, a testamentary trust, or a beneficiary, may not recognize that it needs to take certain steps to remain a qualified shareholder.

These steps are generally described in Section 1361(b)(1)(B) and Section 1361(c)(2)(A) and in Regulations Section 1361-1(h)(1).

By the time the S corporation or the new company shareholder recognizes, for example, that a qualified Subchapter S trust or electing small business trust election has been overlooked, there may be an S termination event triggered.

In many cases, the S corporation itself may not be aware of what its shareholders are doing at the time of the shareholder death. The S corporation generally has no visibility into the estate plans of its various shareholders.

That is, the company or practice itself is generally unaware of who will get shares upon the shareholders' death, and whether those parties are timely making the needed elections.

In many cases, the S corporation may be unaware that one of its shareholders has died. This means that the company's S election can terminate before the TPE is even aware of the event that triggered the S termination.

Such termination events are generally described in Section 1362(d)(2) and Regulations Section 1.1362-4(b).

Let's consider an illustrative scenario. Let's assume a particular decedent owned the S corporation shares in a revocable trust during his or her life. Upon death, the revocable trust becomes an irrevocable trust, with its own income tax filing requirement.

During the first tax year, let's assume that the executor/trustee makes a timely Section 645 election to treat the trust as part of the estate. This election allows the executor/trustee to file one income tax return. That tax return reports the combined activity of the estate and of the qualified revocable trust.

This trust may or may not need to make an S election.

The need to make an election depends on what happens with those S corporation shares—and when it happens. If the S corporation shares are immediately transferred to another trust, then an election may be due within 2-1/2 months of that transfer.[2]

Alternatively, if the S corporation shares are retained for the maximum duration of the Section 645 period,

then an S election may not be due for more than four years. This provision is described in Regulations Section 1.1361-1(h)(1)(iv).

The takeaway is that any time an S corporation shareholder dies, the parties should pay immediate attention to the decedent's plan with respect to:

1. the transfer of the TPE shares and
2. any potential need for, and timing of, required elections.

It is noteworthy that Revenue Procedure 2013-30 may provide automatic relief for taxpayers to make a late S election in these types of scenarios. But the window for relief under this revenue procedure closes three years and 75 days after the election's intended effective date.

The latest intended effective date for an irrevocable grantor trust is two years after the death of a grantor. That window may possibly provide additional time to make the S election.

However, the risk is that these types of required S election oversights may not be discovered until many years later. Such a late stage discovery can trigger the need to seek uncertain relief via a private letter ruling.

S Corporation Gain on the Sale of Assets and Step-Up in the Basis of Shareholder's Shares

A partnership TPE can take advantage of a Section 754 election to help a successor partner equalize his or her inside and outside basis. However, an S corporation has no similar option.

When an S corporation shareholder dies, the decedent's TPE shares basis is stepped up to fair market value.[3] However, there is no adjustment to the inside basis of the S corporation's assets.

As a consequence, the benefit of the step-up may be deferred until the successor S corporation shareholder disposes of his or her stock. This deferral can create a potential trap for the successor shareholders.

Let's consider what would happen if, at a later date, there is a sale of substantially all of the S corporation's assets. Let's assume that the S corporation shareholder does not liquidate his or her interest in that same year.

In our illustrative example, let's assume that an S corporation has an inside net basis of $10 million. That S corporation is owned by shareholders with an outside basis of $50 million (perhaps due to a step-up in basis upon a previous shareholder's death).

If the S corporation sells all of its assets, then $40 million of gain will be triggered. This gain will pass through to the shareholders and increase the S corporation stock basis.

If the shareholders fail to liquidate their ownership interests in that same tax year, the step-up basis will not shield the $40 million of gain. Instead, the loss that will likely occur upon liquidation would be deferred. And, the loss may be deferred to a year when the shareholders have no offsetting gains.

This deferral will trap the loss and defer the related tax benefit until the shareholders can trigger other gains (assuming that is even possible).

A successor S corporation shareholder should be aware of this type of trap. The shareholder should plan to time the recognition of any losses so they occur in the same tax year in which the gain from the S corporation asset sale is reported.

Buy-Sell Agreements and Shareholder Life Insurance

A buy-sell agreement is typically an agreement between:

1. the S corporation shareholders or
2. the S corporation shareholders and the corporation itself.

The agreement specifies the terms of the events, such as the death of the shareholder that will trigger the required transfer of the corporation share.

A buy-sell agreement is important in the case of any privately owned company or professional practice. Such an agreement is particularly important in the case of an S corporation because it can help provide assurance as to how shares will transfer from a deceased shareholder.

Such a buy-sell agreement can help prevent transfers that may otherwise trigger an inadvertent termination of the corporation's S tax status.

Life insurance on the shareholder is the typical means to provide the necessary liquidity to fund these buy/sell transactions. Such life insurance policies are typically owned either:

1. by the S corporation itself or
2. by its shareholders.

The appropriate ownership of the life insurance policies often depends on the structure of the buy-sell agreement.

Buy-sell agreements are typically structured in one of two ways:

1. As a redemption agreement
2. As a cross-purchase agreement

With a redemption agreement, the S corporation has the right (or the obligation) to purchase TPE shares of the deceased shareholder. A cross-purchase agreement gives the other company shareholders the option (or the obligation) to purchase the TPE shares of the deceased shareholder.

The ultimate ownership consequences of a cross-purchase agreement versus a redemption agreement may not differ significantly. But the agreement parties can encounter difficulties if the ownership of the life insurance policies is not in line with the provisions of the buy-sell agreement.

When the buy-sell agreement calls for the S corporation to redeem the deceased shareholder's shares, then the company should typically own and be the beneficiary of the life insurance policy.

Alternatively, if the buy-sell agreement is structured as a cross-purchase, then the shareholders typically should own and be the beneficiaries of the life insurance policies.

Taxpayers who fail to coordinate the ownership of the insurance policies with the terms of the buy-sell agreement can create unnecessary tax problems both for themselves and for the corporation.

Suspended Passive Losses upon Death

Upon the shareholder's death, special rules will apply to suspended passive losses arising from the TPE interest owned at death. The unused losses are allowed as a deduction on the decedent's final personal income tax return.

These unused losses are only allowed to the extent these losses are in excess of the difference between:

1. the basis of the ownership interest in the transferee's hands in excess of
2. the adjusted basis of the ownership interest immediately before the death of the taxpayer.

These rules are also provided in Section 469(g)(2)(A).

This "difference" in basis is typically referred to as the step-up or step-down upon death of the basis of an asset to its fair market value. The rules are provided in Section 1014.

This provision means that effectively to the extent of the basis step-up, suspended passive losses will be permanently disallowed. Those unused passive losses do not carry forward to the decedent's estate, trust, or its beneficiaries.

The rules are provided in Section 469(g)(2)(A). Losses in excess of the basis step-up are allowed on the decedent's final tax return. If there is no basis step-up (for example, because the value of the ownership interest has decreased), then the suspended losses are fully deductible on the decedent's final income tax return.

Suspended Losses Due to Lack of Regular Tax Basis upon Death

Suspended losses due to a lack of regular tax basis will disappear upon the transfer at death from the decedent to his or her estate, trust, and beneficiaries.

Suspended Losses Due to Lack of At-Risk Basis upon Death

Unused at-risk losses will also not carry forward to the decedent's estate, trust, and beneficiaries. Instead, these amounts are added to the tax basis of the ownership interest in the hands of the recipient.

However, because this addition occurs prior to the basis adjustment under Section 1014, there is no net change in the tax basis.

Estate Planning Procedures

There are various planning procedures that can be implemented for older S corporation shareholders. For example, the older S corporation shareholder should consider selling the ownership interest with the suspended losses.

Such a sale would be beneficial if the benefit of triggering the carryovers exceeds any gain on the ownership interest.

State Taxation of the S Corporation

Analysts—and S corporation shareholders—should be aware that many states apply some form of TPE income tax on S corporations. Such a state income tax should not be ignored in the valuation of the S corporation or of the S corporation ownership interest.

Currently, over half of the 50 states impose some form of income tax on a TPE.

Some states impose the regular C corporation income tax rate on the TPE. Effectively, these states ignore the company's S corporation status for state income tax purposes.

Many states impose a reduced corporation income tax rate (for example, a flat 1 percent state income tax rate) on the TPE. While such a reduced income tax rate is advantageous in comparison to the C corporation tax rate, any valuation analysis should recognize that the TPE is still subject to some income tax liability.

In addition, the valuation may consider the possibility that states in which the subject S corporation operates may:

1. impose a de novo income tax on the TPE or
2. increase a currently reduced TPE income tax rate to a higher income tax rate.

In other words, the valuation should recognize the risk that the S corporation may be subject to a greater state income tax liability in the future.

It is also noteworthy that many states require the company to elect TPE status in that state. In other words, state TPE status may not be automatically achieved when the company files a federal S corporation election.

Such states have their own election, periodic filing, and shareholder qualification requirements. Therefore, in some states, there is the risk that the S corporation could inadvertently terminate its state S tax status—even if it does not terminate its federal S tax status.

The takeaway is that analysts—and shareholders and other professionals—should not ignore state income tax considerations in any analysis of an S corporation or other form of TPE.

Summary and Conclusion

Valuation analysts are regularly retained to value S corporations and S corporation ownership interests for gift tax, estate tax, and other transfer tax purposes. In addition, analysts may also be asked to value S corporation ownership interests for income tax, financial accounting, personal financial planning, litigation, and many other purposes.

The TPE economic benefits of S corporation status are generally well known to analysts—and to S corporation shareholders, estate planners, tax counsel, and other professionals.

Over the years, analysts have developed generally accepted methods and procedures for incorporating the value increment (often called a value premium) associated with these TPE benefits into the valuation analysis.

There are risks as well as benefits associated with the S corporation tax status. This discussion summarized many of the typical risks associated with S corporation tax status.

Many of these risks relate to an inadvertent disqualification and termination of the S status. These risks typically affect both (1) the S corporation itself and (2) the company or practice shareholders.

Some of these risks are specific to the transfer of S corporation ownership interests at the time of the shareholder's death. Even these shareholder-death-related risks can affect the S corporation as well as the deceased shareholder's estate.

There are statutory restrictions and limitations on the type of—and the number of—S corporation shareholders. These restrictions may affect the discount for lack of marketability—or other valuation adjustment—related to the S corporation stock. Such restrictions may also affect the owners' retirement exit planning, and ownership transaction strategies.

"[T]he valuation should recognize the risk that the S corporation may be subject to a greater state income tax liability in the future."

These restrictions may have an impact on the company or practice liquidity—or other value adjustment—related to the S corporation business enterprise.

And, analysts should recognize that S corporations are subject to a state-level TPE income tax in many states. Some states apply the regular corporation tax rate to the TPE. Some states apply a reduced income tax rate to the TPE.

Nonetheless, analysts—and other interested parties—should not ignore state income tax considerations in the valuation of an S corporation.

The takeaway of this discussion is that analysts—and shareholders, estate planners, tax counsel, and other professionals—should be aware of the risks and restrictions associated with an S corporation ownership interest.

Analysts should incorporate these negative considerations (either quantitatively or qualitatively) in the S corporation valuation developed for transfer tax planning, compliance, or controversy purposes.

And, analysts—and other interested parties—should also incorporate these risk and restriction considerations in the S corporation valuation developed for transaction pricing, financing collateral analysis, personal financial planning, financial accounting, litigation, or any other purpose.

Notes:

1. Farmers Gin, Inc. v. Commissioner, T.C. Memo 1995-25.
2. See Sections 1361(c)(3) and Regulation Sections 1361-1(j)(6) and 1.1361-1(m)(2).
3. See Internal Revenue Code Section 1014(a)(1).

Robert F. Reilly is a managing director in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.

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Best Practices TABLE OF CONTENTS

Damages Measurements and Income Tax Adjustments

Robert F. Reilly, CPA

Damages analysts are often retained to measure the amount of economic damages suffered by the damaged party in commercial litigation claims related to either (1) a breach of contract or (2) a tort. These damages analysts can serve their clients as either (1) consulting experts or (2) testifying experts. Such analysts apply generally accepted damages measurement methods and procedures to measure the amount of the damages suffered by the inured party. If the damages measurement analysis involves a lost profits or similar damages claim, the analyst has to consider how to handle the income tax liability that will be created as a result of the damages award. That is, if the damaged party is awarded an amount equal to the analyst's damages measurement, that award may become taxable income to the recipient. In order to return the damaged party to the economic position that the party was in before the damages event occurred, the analyst may have to adjust the recommended judicial award amount (or the negotiated settlement amount) for this income tax liability. This discussion summarizes the income tax considerations related to the damaged party's receipt of—and the damaging party's payment of—a damages award.

Introduction

Damages analysts understand that industrial and commercial companies often suffer damages due to the wrongful actions of other parties. Those other parties may include the company employees, customers/clients, competitors, suppliers, company directors, joint venturers, potential acquirers, bankers, contract counterparties, and even government and regulatory authorities.

In addition, the company owners themselves (whether they are corporation shareholders, limited liability company members, or partnership partners) can also suffer damages due to the wrongful actions of other parties. These other parties may include the company itself, the company directors, other company shareholders/owners, the company acquirer (whether actual or attempted), contract counterparties, and others.

For purposes of this discussion, the party (whether institutional or individual) suffering the damages event or events is referred to as the "damaged party."

And, for purposes of this discussion, the party (whether institutional or individual) causing the damages event or events is referred to as the "damaging party."

When parties (whether the companies or the company owners) believe they have been damaged, they will often pursue a legal claim. The damaged party will pursue a claim in order to receive compensation from the damaging party for the amount of the damages suffered.

That legal claim may be pursued through litigation or through some alternative type of legal or dispute resolution proceeding. For example, according to the terms of a particular contract, many contract-related disputes may have to be prosecuted through an arbitration proceeding.

Regardless of the legal venue involved in the dispute, the damaged party typically retains legal counsel to prosecute the claim. And, the damaging party typically retains legal counsel to defend itself against the claim.

Counsel for both parties typically retain (or at least consult with) forensic specialists to assist them in the dispute process. These forensic specialists typically include (but are not limited to) damages analysts.

Damages analysts understand that there are numerous issues involved in any legal proceeding. With regard to most damages claims, there are at least three issues that are relevant to this discussion:

1. Causation
2. Liability
3. Damages measurement

Of course, these three issues are only relevant to this discussion if one first accepts the following foundational assumptions:

1. That the damaged party actually experienced a damages event that was caused by the damaging party
2. That the damaged party suffered a measurable amount of damages due to that damages event.

The principal question related to the causation issue is: who or what caused the damages event (or events) to occur?

The principal question related to the liability issue is: who or what is legally responsible for the damages event (or events)? That liability question considers what party has a duty (contractual or otherwise) to the damaged party.

In contrast, the principal question related to the damages measurement issue is: what is the amount of damages suffered by the damaged party? That damages measurement question typically considers the amount of cash (or the value of property) needed to restore the damaged party to the economic position that the party enjoyed prior to experiencing the damages event (or events).

First, the damages measurement analysis often considers what is typically called the "but for" scenario. That is, what economic (or wealth) position would the damaged party be in "but for" (or without experiencing) the impact of the damages event?

And, second, the damages measurement analysis considers what amount of compensation (whether in cash or in property) should be paid to the damaged party in order to restore that party to the economic (or wealth) position that it enjoyed before—or "but for"—the damages event?

This discussion considers one reason why the answers to the two above-mentioned questions may be different. That is, there may be one quantitative answer to the question: How much damages did the damaged party experience due to the wrongful action of the damaging party?

And, there may be a different quantitative answer to the question: How much should be paid to the damaged party to make that party economically "whole"?

One reason for that difference is the recognition that, in some instances, the judicial award (or negotiated settlement) payment of the damages amount is subject to income taxation.

As mentioned above, in these damages claim disputes, both parties—through their legal counsel—often retain damages-related forensic specialists (hereinafter referred to as damages analysts) to measure the amount of damages experienced by the damaged party.

The damages analyst can be a forensic accountant, an economist, a financial analyst, an engineer, an industry specialist, a valuation analyst, or some other type of forensic professional.

The important point is that the selected damages analyst should have the appropriate experience, expertise, training, and credentials to credibly develop the damages measurement.

Such a damages analyst measures, and provides expert opinions regarding, the amount of the damages suffered by the damaged party. Regardless of the professional background of the damages analyst, the damages measurement analysis should be appropriately supported. And, the damages measurement conclusion should be credible.

The damages analyst is typically not the same professional who assesses, and provides expert opinions regarding, the causation or the liability issues in the dispute.

The damages analyst measures the impact of the damages event (or events) on the damaged party. In so doing, the damages analyst may be instructed by counsel to assume that the damaging party:

1. performed a wrongful action,
2. caused the damages that were experienced by the damaged party, and
3. is legally liable for (and financially responsible for) the damages suffered by the damaged party.

It is typically not the responsibility of the damages analyst to assign fault or blame or responsibility to the damaging party. The damages analyst typically does not independently conclude that the damaging party is the wrongful party.

Rather, the damages analyst quantifies how much the wronged party was damaged—not who is responsible for the damages or who is legally liable for making the damaged party whole.

There is typically a causation expert who analyzes the facts of the dispute and then provides expert opinions regarding the causation issues.

And, there is typically a liability expert who analyzes the facts of the dispute and then provides expert opinions with regard to liability issues.

Defending in his or her expertise, the damages analyst may perform multiple roles in the dispute. That is, if the damages analyst is qualified, he or she may also save the function of the causation analyst or the liability analyst. However, typically, that is not the case.

This discussion focuses on commercial damages measurement issues—not on causation or liability issues. And, this discussion focuses on damages measurement issues in breach of contract or tort disputes in commercial litigation.

In particular, this discussion focuses on one technical, but important, issue related to the measurement of the amount of commercial damages: the income tax considerations related to the damages measurement.

The damages analyst—and the client's counsel—should understand that these income tax considerations relate to:

1. the income recognition and the taxation of any compensation-related payments received by the damaged party,
2. the tax deduction and the taxation of any compensation-related payments made by the damaging party, and
3. the measurement of the recommended amount of the judicial award (or the negotiated settlement) required to make the damaged party whole—after any adjustments necessary with regard to the related income tax considerations.

In addition, this discussion summarizes what the damages analyst—and the damaged/damaging party company, the damaged/damaging party company owners, and the legal counsel for these parties—need to know about the income tax considerations related to damages measurements and damages awards (or negotiated settlements).

Types of Damages Claims

Damages analysts understand that commercial damages claims are typically categorized into the following two categories:

1. Breach of contract claims
2. Tort claims

Of course, breach of contract claims typically generate from the terms and provisions of a commercial contract. Tort claims typically relate to an alleged breach of one party's duty to another party, where that duty is not documented in a contract.

Breach of contract claims may relate to the damaging party's alleged breach of, for example, a contractor/subcontractor agreement, a client/customer purchase agreement, an employment agreement, a noncompetition/nonsolicitation agreement, a supplier agreement, a stock purchase or asset purchase acquisition agreement, a joint venture or joint development agreement, a franchise agreement, an intellectual property license, a real estate lease, or any other type of commercial contract.

The contract should specify the respective duties and responsibilities of the counterparties. If one of the contract counterparties allegedly violates a specified duty or responsibility, then the other contract counterparty may be damaged as a result of that breach of contract.

Tort claims may relate to the damaging party's alleged breach of a noncontractual duty or a responsibility.

For example, a public company and its directors have duties to the company's shareholders. A private company's controlling shareholder has duties to the company's noncontrolling shareholders. A lender financial institution has duties to its borrowers. Competitor companies have certain duties to each other.

Partners have certain duties to each other (in addition to the duties that may be documented in the partnership agreement). Public companies have duties to both securities market regulatory authorities and to the investor market in general. Trustees have duties to the trust beneficiaries.

If one party commits a tortious action and violates its duty to another party, then that other party may be damaged as a result of the tortious action.

The damages analyst typically considers the above-described categorization of commercial damages claims. This damages claim categorization—as either a breach of contract or a tort—may affect which of the generally accepted damages measurement methods the analyst applies in a particular damages measurement analysis.

The damages analyst also typically considers another categorization regarding damages claims. That is, the analyst considers whether the receipt of the damages award (or of the negotiated settlement) is a taxable event to the damaged party.

In other words, the analyst considers if the receipt of the damages award (or the settlement) is ordinary income, a capital gain or loss, or a nontaxable event to the damaged party.

The analyst may also consider whether or not the payment of the damages award (or the settlement) results in an income tax deduction to the damaging party.

And, finally, the analyst may consider these income tax consequences when recommending the amount of the judicial award (or the amount of a negotiated settlement) with regard to the damages claim.

Income Tax Considerations

Even during the normal course of business, a company or a company shareholder may become the recipient of—or the payer of—a damages-related judicial judgment or negotiated settlement. That judicial judgment or negotiated settlement may be the result of a commercial litigation, an arbitration, or some type of alternative dispute resolution proceeding.

The damages analyst understands that the income tax considerations of such judgments, awards, or settlements can affect both the recipient and the payer.

And, the income tax considerations related to the commercial damages measurement may affect the amount of the judgment or the settlement that would be required to make the damaged party economically "whole."

The damages analyst understands that these income tax issues affect both the recipient and the payer of the damages judgment, award, or settlement.

The specific terms of the judgment or the settlement typically have an impact on whether the payment is:

- tax deductible or not tax deductible,
- taxable income or not taxable income, and
- if taxable income, whether the income is treated as ordinary income or capital gain.

As with most taxation issues, the taxpayer has the burden of proof regarding both the tax treatment and the income characterization (whether ordinary income or capital gain) of the judgment or settlement payment.

These issues are typically determined by reference to the particular language included in the underlying litigation documents. Such documents include the various pleadings, the court's order or the arbitration award, and/or the settlement agreement.

All parties to the dispute and their litigation counsel should consult with tax counsel regarding these taxation issues when drafting such litigation-related documents.

The income tax treatment of the payment is not influenced by whether the award is the result of a court order, an arbitration award, or a settlement agreement between the parties.

However, generally, taxation issues are easier to deal with in the case of a settlement agreement that is drafted by counsel to the parties. The reason for this statement is because the court or the arbitrator may not be particularly sensitive as to what wording to include in the final litigation documents in order to influence the desired income tax treatment.

Therefore, taxation issues are often more difficult to deal with in the context of a court's order or an arbitrator's award.

"The damages analyst understands that the income tax considerations of such judgments, awards, or settlements can affect both the recipient and the payer."

The Origin of the Damages Claim

The origin of the damages claim may directly influence the tax treatment of the judicial award or the settlement payment. Many courts have applied the so-called origin-of-the-claim test with regard to this taxation issue. That is, the courts typically consider the question: "In lieu of what was the damages payment made?"

This consideration affects the tax characterization of the damages payment. This test has been applied by the courts for many decades, at least since the *Raytheon Production Corp v. Commissioner* decision.[1]

For the recipient of a judicial award or settlement payment, the origin-of-the-claim test may determine whether the payment receipt is taxable or not taxable. If the receipt of the judicial award or settlement payment is taxable, then this test may determine if the income should be characterized as ordinary income or as capital gain.

Typically, a damages award received pursuant to either a court's judgment or a negotiated settlement is considered to be taxable income to the recipient.

However, the receipt of certain types of damages payments is not considered to be taxable income.

Examples of such nontaxable receipt of payments include receipts of gifts or inheritances, payments as compensation for a personal physical injury, certain disaster relief payments, amounts for which the taxpayer did not previously receive a tax benefit, cost reimbursements, the recovery of capital or of property, or a business acquisition purchase price adjustment.

A damages award is typically taxable as ordinary income if the payment relates to a claim of lost profits. However, such an award may be characterized as a capital gain (to the extent that the amount of the damages exceeds the property's tax basis) if the claim relates to the damage of a capital asset.

For the payer of the damages award, the origin-of-the-claim test will determine whether the payment is tax deductible or not tax deductible. In addition, the test will determine:

1. whether a tax deductible payment will be currently deductible or
2. whether the payment has to be capitalized (and perhaps deducted at a later time).

For example, a damages payment related to a personal transaction will be considered a nondeductible personal expense.

In contrast, a damages payment related to a business activity may be deductible under Internal Revenue Code Section 162. And, business-related damages payments related to interest, taxes, or certain losses will be deductible under Section 163, Section 164, or Section 165, respectively.

Certain types of damages payments are not tax deductible to the payer. Other types of damages payments would have to be capitalized (and perhaps deducted at a later time).

For example, the damages payment would have to be capitalized when the payer receives an intangible asset or intellectual property license, say as part of a negotiated settlement, in exchange for the settlement payment.

Again, the burden of proof is on the taxpayer to establish the appropriate income tax treatment related to the receipt or the payment of the damages judgment or negotiated settlement.

The types of documents that the Internal Revenue Service (the "Service") typically considers with regard to the tax treatment issue include the following: the legal filings in the dispute, the terms of a settlement agreement, any correspondence between the parties to the dispute, any internal memos of the parties, any party press releases, company annual reports, and news-related publications.

As a general guideline, the Service considers the initial complaint (or the equivalent legal document) to be the most persuasive evidence. This general guidance is presented in Revenue Ruling 85-98.

Allocation of the Damages Payment

Sometimes the judicial award payment or the negotiated settlement payment can cover more than one damages claim. In that case, the parties to the dispute may have to allocate the payment for federal income tax purposes.

Such an allocation is necessary when:

1. one part of the payment represents a taxable event and
2. another part of the payment relates to a nontaxable event.

In addition, such an allocation may be necessary when there are either multiple plaintiffs (claimants) or multiple defendants (respondents).

Some of the factors that the parties to the dispute should consider in that payment allocation process include the following:

- Who made and who received the payment?
- Who was economically harmed or economically benefited by the damages event?
- Which party were the allegations asserted against?
- Which party controlled the litigation?
- Was the dispute-related costs or receipts required to be shared contractually?
- Was there joint and several liability among the parties related to the damages claims?

The court's order or the settlement document may provide for a payment allocation in the document's narrative text. If a payment allocation is already specified in

the judicial judgment, then the Service and the taxpayers are typically bound by that allocation.

In addition, the Service will typically accept a payment allocation that is specified in a negotiated settlement agreement.

However, the Service may challenge a settlement-related allocation if the Service concludes that the taxpayer had another (nontaxation) reason for the agreed-upon payment allocation.

As with most issues, the taxpayer has the burden of proof with regard to defending the claimed award allocation before the Service.

A Statutory Deduction Disallowance

The Internal Revenue Code specifically disallows an income tax deduction related to certain payments made or liabilities incurred with respect to a court's judgment or a negotiated settlement.

As amended by the Tax Cuts and Jobs Act ("TCJA"), Section 162(f) disallows a tax deduction (under any provision of Chapter 1) related to amounts paid or incurred:

1. by a lawsuit, an agreement, or otherwise;
2. to, or at the direction of, a government or governmental entity; and
3. in relation to a violation of law—or to an investigation or inquiry into a potential violation of law.

This tax deduction disallowance does not apply to payments for:

1. the restitution (including the remediation of property),
2. taxes due, and
3. amounts paid pursuant to a court order when no government or governmental agency is a party to the dispute.

The Treasury Regulations also indicate that this tax deduction disallowance does not apply:

1. to a dispute in which the government enforces its rights as a private party—for example, in a breach of contract dispute—or
2. to routine audits or inspections not related to a possible wrongdoing.

The restitution exception to the tax deduction disallowance only applies if the court order or the settlement agreement identifies the damages payment as:

1. a restitution or remediation payment or
2. a payment to come into compliance with the law (collectively referred to as the identification requirement).

In addition, the taxpayer has to establish that the damages payment was made:

1. for restitution or remediation or
2. to come into compliance with the law (collectively referred to as the establishment requirement).

The taxpayer may satisfy the identification requirement if the court order or the settlement agreement specifically states that the payment:

1. constitutes restitution or remediation or
2. is for coming into compliance with the law—or uses some form of similar language.

The taxpayer may satisfy the establishment requirement by providing the Service with documentation evidence of "the elements of establishment."

The TCJA also added Section 162(g) related to tax deductions with regard to damages payments. Section 162(g) disallows an income tax deduction (under any provision of Chapter 1) for:

1. a settlement or other payment related to sexual harassment or abuse and
2. the corresponding attorneys' fees—if there is a nondisclosure agreement.

However, this Section 162(g) tax deduction disallowance does not apply to the attorneys' fees incurred by the sexual harassment/abuse victim.

There are various other Internal Revenue Code sections that disallow income tax deductions related to certain types of damages payments.

For example, Section 162(i) disallows a tax deduction related to illegal bribes and kickbacks. And Section 162(q) disallows a tax deduction related to the treble damages imposed for antitrust violations.

Adjusting the Damages Measurement for Income Tax Consequences

The damages analyst will often adjust the initial damages measurement amount for the income tax consequences of the damages award receipt. Without such a tax-related adjustment to the recommended award/settlement, the damaged party may not be "made whole" by the receipt of the damages award.

The damaged party may not be "made whole" by the damages award receipt if the damages award or the settlement payment is recognized as taxable income to the damaged party recipient.

In addition, without such a tax-related adjustment, the damaging party may benefit from the income tax deduction associated with certain damages-related payments.

For example, let's consider a hypothetical breach of contract litigation claim. Let's assume that Alpha Company is the damaged party and that Beta Company is the damaging party. In this hypothetical example, Beta wrongfully caused Alpha to suffer $24 million of damages related to lost profits associated with the contract breach.

Alpha brings a damages claim against Beta. The judicial finder of fact concludes that Beta caused the lost profits damages event and is liable for the lost profits damages to Alpha.

The finder of fact orders Beta to pay a $24 million damages award to Alpha. In compliance with the judgment, Beta pays the $24 million damages award amount to Alpha.

Let's further assume that the receipt of the lost-profits-related damages award is recognized as taxable income to Alpha. To simplify the income tax liability calculation, let's assume a 25 percent effective combined federal and state income tax rate for Alpha.

Alpha suffered $24 million in lost profits damages related to Beta's wrongful breach of contract. If Alpha receives a $24 million damages award payment, Alpha will pay $6 million in income taxes. After tax, Alpha will be left with only $18 million cash remaining.

Accordingly, Alpha may not be "made whole" by the receipt of the $24 million damages award.

If Alpha recognizes taxable income related to the $24 million damages award receipt, it is likely that Beta will qualify for an income tax deduction related to the award payment. That is, after considering the income tax impact, Beta will end up with $18 million less cash (even though Beta paid the $24 million payment to Alpha).

So, while Beta was judicially determined to be liable for the $24 million of damages suffered by Alpha, Beta will only suffer an $18 million negative economic impact (after all income tax considerations).

And, although Alpha was judicially determined to have suffered $24 million in damages due to the wrongful actions of Beta, Alpha will only recover $18 million in economic benefit (after all income tax considerations).

Damages analysts should be aware that there are two different tax-related adjustment procedures that the analyst may apply to account for these income tax considerations. These adjustment procedures consider the impact of the above-illustrated income tax considerations on:

1. the damages measurement analysis and
2. the damages award recommendation conclusion.

The first adjustment procedure is to calculate the present value of the pretax lost profits suffered by the damaged party using an after-tax present value discount rate.

In theory, this tax-related adjustment procedure increases the amount of the lost profits damages by the amount of the income tax impact on the receipt of the lost profits damages award.

This adjustment procedure may be the less frequently applied of the two tax-related adjustment procedures. This adjustment procedure works efficiently in a lost profits damages measurement calculation.

However, this adjustment procedure is generally less applicable to many other damages measurement methods—such as the cost to cure damages measurement method, for example.

And, the apparent mismatch in the damages measurement (i.e., the application of an after-tax present value discount rate to a pretax lost profits amount) may be somewhat difficult for a damages analyst to explain to a judicial finder of fact in the dispute.

To be clear, this pretax lost profits/after-tax discount rate procedure is in compliance with generally accepted damages measurement standards and practices. This adjustment procedure is described (and recommended) in several forensic accounting textbooks and other forensic analysis professional literature.

The benefit of this adjustment procedure is that it is relatively easy to apply mathematically. The drawback of this adjustment procedure is that it appears counter-intuitive to many finders of fact—and to many damages analysts.

The second adjustment procedure is generally applicable to all damages measurement methods. This second adjustment procedure is more frequently applied by damages analysts. Additionally, this adjustment procedure is fairly easy for a damages analyst to explain to a judicial finder of fact—and to other parties involved in the dispute.

In this second tax-related adjustment procedure, the damages analyst simply identifies and quantifies the two individual components of the recommended judicial award.

The two individual components of the recommended award are:

1. the amount of the damages suffered by the damaged party (on a tax neutral basis) and

2. the amount of the income tax liability (if any) created by the receipt of the damages award payment.

In this second tax-impact adjustment procedure, the analyst is not adjusting the measurement of the damages suffered by the damaged party. Rather, the analyst is reaching two conclusions:

1. The measurement of the amount of damages suffered
2. The measurement of the judicial award (or settlement amount) required to make the damaged party whole—after considering the payment of income taxes

Let's return to the Alpha and Beta breach-of-contract-related dispute example. To apply this second tax-related adjustment procedure, the damages analyst will quantify both:

1. the $24 million amount of the lost profits damages that Alpha suffered as a result of Beta's wrongful actions and
2. the amount of the income tax liability that Alpha will incur with regard to the receipt of the $24 million damages award payment.

The sum of these two economic components represents the total amount of the judicial award that the analyst would recommend to the finder of fact.

So, in the above example, the analyst would conclude the recommendation with regard to the total amount of the damages award (or the negotiated settlement) as presented in Exhibit 1.

That is, the analyst would recommend that the judicial finder of fact award (or that the parties agree to in a negotiated settlement of) a $32 million total payment to Alpha.

Based on the receipt of the $32 million total payment, Alpha will incur an $8 million (i.e., $32 million × 25 percent effective income tax rate) income tax liability. After that $8 million income tax liability is expensed (i.e., paid to the federal and state taxing authorities), Alpha will be left with $24 million.

That is, as a result of the receipt of a $32 million total judicial award payment, Alpha will be made whole with regard to the $24 million of lost profits damages. That $24 million damages measurement amount relates to Beta's wrongful breach of contract damages event.

In this simplified illustrative example, as a result of the damages event caused by Beta's wrongful actions, Alpha's economic position decreased by $24 million. This $24 million is the analyst's measurement of the amount of lost profits damages suffered by Alpha.

Based on the $32 million total payment from Beta, Alpha's economic position (after the payment of income taxes) would increase by $24 million. Accordingly, the $32 million (pretax) payment is required in order to make Alpha whole after experiencing the economic impact of Beta's breach of contract damages event.

This $32 million is the analyst's recommended judicial award related to the $24 million in lost profits damages suffered by Alpha.

Again, assuming the type of damages in this illustrative example relates to a taxable event, Beta will typically benefit from a $32 million income tax deduction if Alpha recognizes $32 million in taxable income.

In other words, after considering the income tax impact (assuming the illustrative 25 percent effective income tax rate), the $32 million payment will decrease Beta's economic position (after considering the income tax impact) by $24 million.

The damages analyst should be aware that this second tax adjustment procedure is often applied by analysts when recommending the total amount of a judicial award (or a negotiated settlement). This is because this second tax adjustment procedure separately identifies and quantifies the impact of income taxes on the recommended amount of the damages award.

This tax-related adjustment procedure clearly identifies that the total recommended damages award should include two separate components:

Exhibit 1
Alpha Company v. Beta Company Damage Claim
Total Amount of the Analyst's Damages Award Recommendation
Applying the Income Tax Adjustment Procedure

Measurement of the Amount of the Lost Profits Damages Suffered by Alpha	$24 million
Divided by: 1 – the 25% Effective Income Tax Rate	75%
Equals: Total Damages Payment (the analyst's recommended total judicial award or total settlement amount) Required to Make Alpha Whole after the Damages Event	$32 million

"In the development of the damages analysis, . . . all of the parties to the dispute . . . should consider all of the income tax consequences to the parties to the dispute."

1. The measurement of the amount of the damages suffered by the damaged party
2. The income tax impact on the damaged party of the receipt of the damages award payment (or the settlement payment)

Summary and Conclusion

Damages analysts understand that industrial or commercial companies may suffer commercial damages due to the wrongful actions of various parties.

These commercial damages may be caused by a breach of contract, a tortious act, or some other reason. And, the wrongful party (i.e., the damaging party) may be a competitor, customer, employee, shareholder, banker, supplier, potential or actual acquirer, joint venturer, licensor/licensee, government agency, or some other party.

When an industrial or commercial company is damaged, the company typically retains legal counsel to prosecute the legal claim. Such counsel typically retain a forensic accountant, economist, engineer, valuation specialist, industry consultant, or some other type of damages analyst to measure the amount of damages suffered by the damaged party.

The damages analyst is typically retained to measure the amount of damages suffered by the damaged party as a result of the alleged wrongful actions of the damaging party. The damages analyst typically applies generally accepted damages measurement methods and procedures.

Typically, the damages analyst does not assess or opine on the causation issues or the liability issue related to the litigation claim. Typically, other specialists serve as causation analysts and/or liability analysts in the commercial damages dispute.

In the development of the damages analysis, the damages analyst—and all of the parties to the dispute—should consider all of the income tax consequences to the parties to the dispute.

Tax counsel may have to advise all of the parties to the dispute—including each party's litigation counsel and each party's damages analyst—regarding such income tax considerations.

Damages analysts understand that there are income tax consequences related to the receipt of—and the payment of—amounts related to a damages-related judicial order or negotiated settlement.

The taxable income recognition, the tax deduction, and the income character (whether ordinary income or capital gain) of the payments typically depend on:

1. the type of the damages claim and
2. the identity of the damaged party and the damaging party.

These taxation-related issues are typically reflected in the legal documents related to the dispute. In particular, analysts should be aware that certain income tax deduction disallowances may apply with regard to the damages award payments.

All parties to the commercial dispute should consider the income tax consequences of any damages payment:

1. when negotiating a dispute settlement agreement or
2. when recommending a court order or an arbitrator's award.

In addition to the damaged party and the damaging party, damages analysts, litigation counsel, and other professionals involved in the dispute should consider these taxation issues.

Tax counsel may be called on to advise the parties with regard to such tax consequences. With some planning on the part of tax counsel—and the damages analyst—and with the cooperation among the parties to the dispute—some unfavorable tax consequences could be avoided.

In any event, all relevant income tax consequences should be accounted for:

1. in the analyst's damages measurement,
2. in the analyst's damages award recommendations or deliberations,
3. in the dispute settlement negotiations, and
4. in the counsel's litigation prosecution and defense.

Note:

1. Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944).

Robert F. Reilly is a managing director in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.

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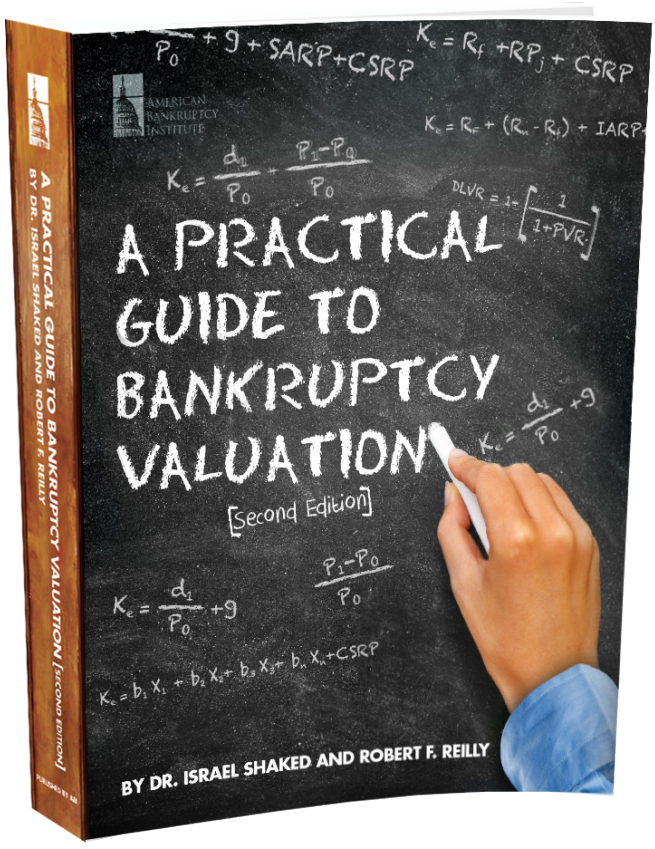

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A CITIZENS COMPANY

A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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Best Practices for Economic Obsolescence Measurements

Robert F. Reilly, CPA

This discussion considers the application of the cost approach to appraise special-purpose industrial and commercial property. This discussion focuses on the identification and measurement of economic obsolescence within application of the cost approach. This topic is particularly relevant to the unit principle appraisals of public utility and utility-type property for state and local ad valorem tax purposes. After considering the differences between unit principle property appraisals and summation principle property appraisals, this discussion describes and illustrates the generally accepted economic obsolescence measurement methods (with particular emphasis on the capitalization of income loss method). Appraisers who develop unit principle property appraisals have to be able to (1) identify and distinguish (qualitatively and quantitatively) the various elements (or types) of obsolescence in a cost approach analysis of special-purpose industrial and commercial property, (2) explain and apply the generally accepted economic obsolescence measurements methods, (3) report and defend the economic obsolescence measurement analysis in a unit principle property tax appraisal, and (4) respond to typical taxing authority objections related to the proposed economic obsolescence adjustment.

Introduction

This discussion focuses on the development of, and the reporting of, economic obsolescence measurements as a component of a cost approach appraisal of industrial and commercial property.

The cost approach is a generally accepted approach that is often applied to develop an appraisal of industrial or commercial property prepared for any purpose. In particular, the cost approach is typically the primary approach applied in the appraisal of special-purpose industrial or commercial property.

This discussion focuses on the appraisal of special-purpose industrial and commercial property for state and local ad valorem taxation purposes. This discussion is relevant to special-purpose property appraisals developed for ad valorem tax planning, compliance, and controversy purpose.

This discussion focuses on unit principle property appraisals—in contrast to summation principle property appraisals. These technical appraisal terms will be defined below.

In summary, the unit principle of property appraisal is applied to appraise complex special-purpose properties that are physically, functionally, and economically integrated. Examples of such properties include electric generation plants, oil and gas refineries, pipelines, gas distribution systems, cable television systems, marinas, mining operations, sports stadiums, telecom systems, railroads, airlines, and many other types of properties.

The unit principle of property appraisal can be applied to complex property appraisals developed for any

purpose. However, this discussion focuses on appraisals developed for state and local property tax purposes.

The identification and measurement of economic obsolescence is one component of every cost approach appraisal of property value. Specifically, this discussion considers the following economic obsolescence measurement topics:

- Introduction to unit principle property appraisal concepts
- Economic obsolescence concepts
- Principles of economic obsolescence measurement
- Generally accepted economic obsolescence measurement methods
- Top 10 most typical assessor objections to economic obsolescence measurements
- Other typical assessor objections to economic obsolescence measurements
- Assessment authority considerations regarding obsolescence adjustments
- Summary and conclusion and bibliography

Unit Principle and Summation Principle Property Appraisal Concepts

In the property tax appraisal of special-purpose industrial and commercial property, appraisers (and assessment authorities) often apply the unit principle of property appraisal to appraise a bundle of operating property collectively—as "a unit" or a single collection of property.

In the vernacular, appraisers apply the unit principle to appraise the total property unit from the "top down."

The generally accepted unit principle property appraisal approaches and methods conclude a single value for the total property bundle.

This total unit value may be allocated to the individual property components within the total taxpayer property unit.

Such a total unit value allocation procedure may be necessary for a taxpayer property that crosses multiple taxing jurisdictions (such as a pipeline or gas distribution system). This allocation process allows the taxpayer (and the taxing authority) to assign a value to the property located in each individual taxing jurisdiction.

In the property tax appraisal of general-purpose commercial property (such as warehouses, hotels, office buildings, apartment buildings, etc.), appraisers (and assessment authorities) often apply the summation principle of property appraisal.

Appraisers (and assessment authorities) apply the summation principle to individually appraise each component of a bundle of operating and nonoperating property—as a portfolio of independent properties.

In the vernacular, appraisers apply the summation principle to appraise the total property portfolio from the "bottom up."

The generally accepted summation principle of property appraisal approaches and methods concludes an individual value for each property in the total property portfolio (e.g., each property in a portfolio of hotels, office buildings, apartment buildings, etc.). Those individual property values may be "summed" to conclude the value of the total property portfolio.

When do appraisers apply the unit principle of property appraisal (instead of the summation principle of property appraisal)?

Particularly with regard to property appraisals developed for state and local ad valorem taxation purposes, appraisers typically apply the unit principle of property appraisal in the following instances:

- When it is required by statute or regulation.
- When the individual property components are physically, functionally, and economically integrated.
- When financial or operational data for the individual property components are not available.
- When the individual property components would be bought or sold collectively—as a "unit."

Property owners (and other interested parties) often ask if there is a value conclusion impact of applying the unit principle of property appraisal versus the summation principle of property appraisal.

The answer is that a unit principle property appraisal and a summation principle property appraisal should conclude approximately the same property value if:

- both appraisal principles are applied to exactly the same bundle of property,
- both appraisals apply consistent valuation variables, and
- there are no scope restrictions on either appraisal

Historically, the unit principle of property appraisal was called the utility principle of property appraisal. That is because the unit principle of property appraisal was originally developed to appraise public utility property. In fact, the unit principle of property appraisal was originally developed to appraise rate-based, regulated public utility property.

However, today this unit principle of property appraisal is frequently applied by state and local tax assessment authorities to value both regulated utility property and many types of nonregulated utility-type property.

Generally Accepted Unit Principle Property Appraisal Approaches and Methods

The following list includes many of the generally accepted unit principle property appraisal approaches and methods:

- Income approach
  - Discounted cash flow method (also more generally known as the yield capitalization method)
  - Direct capitalization method
- Cost approach
  - Historical cost less depreciation method
  - Original cost less depreciation method
- Market approach
  - Direct sales comparison method
  - Stock and debt method

Appraisers typically consider each of these approaches and methods in the unit principle property appraisal. Appraisers typically apply each approach and method for which there are meaningful empirical data available to develop the component valuation variables.

In the selection and application of unit principle approaches and methods, ultimately, appraisers attempt to emulate the analyses of—and the actions of— market participants.

The names of some of these unit principle approaches and methods may sound the same as the names of corresponding summation principle approaches and methods. However, experienced property appraisers understand that the particular valuation procedures and analyses may be quite different between the two property appraisal principles.

And, the particular valuation variables applied and data sources used may be quite different between the two property appraisal principles.

It is noteworthy that, in a unit principle property appraisal, the terms "property" and "assets" are not the same. The term "property" is a legal term, generally defined by *Black's Law Dictionary*, but specifically defined by state statutes. The term "asset" is an accounting term, defined by the Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 8.

It is noteworthy that not all property may be recorded as an asset on a balance sheet prepared in compliance with U.S. generally accepted accounting principles ("GAAP"). And, not every asset recorded under GAAP may be legally protected as property in a particular taxing jurisdiction.

For purposes of this discussion only, these two different terms may be used interchangeably.

Differences in Unit Principle versus Summation Principle Appraisal Procedures

There are numerous differences between the unit principle and the summation principle with regard to both:

1. appraisal procedures performed and
2. valuation variable data sources applied.

The more significant of these many differences are summarized in Exhibit 1.

It is noteworthy that without numerous intentional adjustments, the unit principle of property appraisal and the summation principle of property appraisal:

1. will appraise two fundamentally different bundles of property and
2. will apply two fundamentally different sets of valuation variables/assumptions.

The Unit Principle Property Appraisal Is Not a Business Valuation

A unit principle property appraisal is not a business valuation! These two valuation analyses apply different sets of generally accepted valuation approaches.

That is, the property appraisal cost approach is not a generally accepted business valuation approach. And, the asset-based business valuation approach is not a generally accepted property appraisal approach. The unit principle of property appraisal cost approach is not the business valuation asset-based approach!

These two different types of valuation analyses have two fundamentally different objectives. The unit principle of property appraisal concludes the value of property operating on a value-in-use basis. That means that the valuation premise applied in the analysis is the going-concern premise.

The business valuation concludes the value of business debt and equity securities. That is, the valuation subject of the analysis is a going-concern business enterprise.

Exhibit 1
Unit Principle Appraisal versus Summation Principle Appraisal
Differences in the Property Appraisal Procedures Applied

Valuation Variable	Unit Principle Appraisal	Summation Principle Appraisal
Income Approach		
Type of income considered	Business operating income—from the sale of goods and services	Property rental income
Term of income	Perpetuity	Over the property's useful economic life
Asset replacement	Perpetual property replacements	Property retirement after the property's useful economic life
Discount rate	Extracted from capital market data	Market participant-required rates
Long-term growth rate	Business income growth—from all assets in place	Rental income growth—from specific property only
Direct cap rate	Discount rate minus long-term growth rate	Extracted from sales of comparable properties
Cost Approach		
Cost metric	Historical/original cost	Replacement/reproduction cost new
Physical depreciation	Age/life, total based on accounting data	Observed, individually based on effective age/ condition
Functional obsolescence	Aggregate excess capital costs; capitalized excess operating expense (in perpetuity)	Individual excess capital costs; capitalized excess operating expenses (over useful economic life)
Economic obsolescence	Actual vs. required business income margins or business income return on investment	Location-specific rental income loss capitalized over property's useful economic life
Market Approach		
Comparables selected	Comparable operating businesses sold; stock and debt securities of "comparable" public companies	Comparable individual properties sold
Adjustments based on	Size, profit margin, return on investment, growth rate	Location and physical characteristics
Pricing multiples applied	Price/business income metric	Price/physical or operational capacity metric

These two different types of valuation analyses conclude the value of two fundamentally different bundles of assets. These two different bundles of assets are illustrated in Exhibit 2.

In Exhibit 2, the acronym PVGO stands for "present value of growth opportunities." PVGO is the present value of all future tangible property and all future intangible property that does not yet exist on the appraisal's valuation date. PVGO includes investor expectations for the subject business enterprise with regard to future M&A transactions, future new products and services, future new territories and innovations, and future expansionary capital expenditures.

After a business acquisition, this PVGO value typically would be recorded as goodwill on a GAAP basis balance sheet.

This PVGO value cannot be subject to property tax. This is because the PVGO property does not exist on the property tax assessment date.

The term "intangible investment attributes" include the following value increments associated with using stock and bond capital market data in the application of the unit principle appraisal analysis:

- Value of stock market liquidity (including quick sale, low transaction costs, certain price)
- Value of stock market limited investor liability
- Value of having no capital calls on public securities
- Value of expected investment appreciation (vs. expected investment depreciation)
- Value of having no investment replenishment expenditures (vs. maintenance capital expenditures)
- Value of applying capital gain tax (vs. ordinary income tax on depreciation recapture) on any gain at sale

After a business acquisition, this value of intangible investment attributes typically would be recorded as goodwill on a GAAP-basis balance sheet.

This value of intangible investment attributes cannot be subject to property tax. That is because these intangible investment attributes are not considered to be property.

The following is the typical formula for application of the unit principle of property appraisal cost approach:

Historical (may be original) cost
– Physical depreciation
– Functional obsolescence
– Economic obsolescence
= Unit value indication

Each of these four cost approach analysis components (one cost metric and three depreciation metrics) are typically developed in the aggregate—or as a "unit." The data regarding the cost metric and the physical depreciation metric are typically extracted from the property owner's continuing property record ("CPR") or from a similar property accounting data set.

In the unit principle cost approach analysis, functional obsolescence is typically measured in the aggregate—or at the "unit" level.

However, it may be possible that the unit-level functional obsolescence may be caused by one or more individual property components within the overall unit (e.g., an inefficiency at one compressor station or one gas processing plant—as a component of the total pipeline unit). In the unit principle cost approach analysis, functional obsolescence typically relates to an inadequacy or a superadequacy within the unit.

In the unit principle cost approach analysis, economic obsolescence is typically measured in the aggregate—or at the "unit" level.

Since all unit property components contribute to the economically integrated unit, all property components share the unit-level economic obsolescence. In the unit principle cost approach analysis, economic obsolescence typically relates to an inadequacy in the unit's profitability or return on investment. Both metrics can be measured in many different ways.

Functional obsolescence is caused by factors internal to the taxpayer's property unit. Functional obsolescence often manifests as an inadequate unit-level return on investment.

Exhibit 2
Unit Principle Property Appraisal Bundle of Assets Appraised versus Business Valuation Bundle of Assets Appraised

Unit Principle Appraisal Assets Appraised	Business Valuation Assets Appraised
Working capital accounts	Working capital accounts
Real estate	Real estate
Tangible personal property	Tangible personal property
Intangible personal property	Intangible personal property
	PVGO
	Intangible investment attributes

That inadequate return on investment may be caused by either:

1. inadequate profit or
2. superadequate investment.

The inadequate unit-level profit is typically due to excess operating expenses. These excess operating expenses relate to the operation of the unit's real estate and/or tangible personal property.

The excess operating expense is typically measured as the difference between:

1. the actual unit expense category (e.g., fuel expense, maintenance expense, etc.) and
2. the corresponding budgeted/projected expense level, historical expense level, industry average expense level, and other benchmark expense level.

The excess operating expense is typically capitalized as an annuity in perpetuity in order to measure the unit-level functional obsolescence.

The superadequate investment typically relates to excess capital costs. These excess capital costs relate to the taxpayer unit having more (or having the most costly) real estate and/or tangible personal property than it needs in order to operate at its current volume.

This unit-level functional obsolescence superadequacy is typically measured as the difference between:

1. the actual investment in the actual property and
2. the investment needed to buy/build the ideal property (e.g., smaller diameter pipeline, fewer/smaller compressor stations, etc.).

A unit can experience both excess operating expenses and excess capital costs. However, the property appraiser should be diligent to not double-count the amount of functional obsolescence.

In a unit principle property appraisal, an inutility analysis is sometimes applied to measure functional obsolescence. This is because inutility measures the amount of the taxpayer's property capacity that is not needed for the current volume of business operations.

Economic obsolescence is caused by factors external to the taxpayer unit property. Economic obsolescence often manifests as an inadequate unit-level (1) profit margin or (2) return on investment.

These economic metrics can be measured many different ways. For example, the unit-level profit margin can be measured in any of the following ways:

- Before or after taxes
- Before or after debt service
- Before or after depreciation expense
- Based on changes in revenue (selling price and/or volume)
- Based on changes in material, labor, or overhead expenses

For example, the unit-level return on investment can be measured in any of the following ways:

- Before or after tax
- Before or after debt service
- Before or after depreciation expense
- Based on gross or net investment
- Based on historical investment or current value indication
- Based on changes in expected growth rate

Economic obsolescence can be caused by any factor that is external to the unit's real estate or tangible personal property, including the following:

- Changes in technology
- Changes in industry conditions
- Competitor actions
- Property owner management actions
- Regulatory factors
- Income tax rate changes
- Interest rate changes
- Many other factors

In a unit principle property appraisal, the unit-level economic obsolescence is typically measured as either:

1. the amount of economic deficiency capitalized as an annuity in perpetuity or
2. the percentage difference between the unit's actual profit/return metric and a market-required profit/return metric.

External Obsolescence versus Economic Obsolescence

The term external obsolescence includes two specific types of obsolescence:

- Locational obsolescence
- Economic obsolescence

Locational obsolescence is a decrease in property value due to location-related or "neighborhood" factors. Some examples of locational obsolescence include the following:

- A new structure is built blocking a high-rise apartment's view of the waterfront.
- A budget motel is built next to a luxury hotel.
- A trailer park is built next to a country club.

Locational obsolescence is typically a consideration in the application of a summation principle property appraisal and not in the application of a unit principle property appraisal.

Locational obsolescence is typically measured as the capitalization of rental income loss—over the subject property's useful economic life.

Economic obsolescence is a decrease in property value due to any external factors other than location or change in "neighborhood." Economic obsolescence is typically a consideration in a unit principle property appraisal but may also be a factor in a summation principle property appraisal.

So, economic obsolescence is one subset or component of external obsolescence. Accordingly, the terms economic obsolescence and external obsolescence are not exactly synonyms.

Economic Obsolescence Measurement Principles

There is a difference between (1) identifying the existence of economic obsolescence and (2) measuring the unit-specific amount of economic obsolescence. Preliminary analyses, analyses of industry-wide data, or analyses of unit data not involving some investment metric are often developed to identify the existence of economic obsolescence in the taxpayer industry.

Economic obsolescence is often measured on a comparative basis. The economic obsolescence measurement comparison is often simplified as follows: What you have versus what you want.

The "what you have" metric is typically the subject unit's actual economic metric. The "what you want" metric is typically the market participants' required or benchmark level of the same economic metric.

The market participants' required or benchmark economic metric should be based on empirical data. That is, it should be derived from industry, public company, or subject taxpayer historical or prospective data.

The difference between the "what you have" or the actual economic metric and the "what you want" or benchmark economic metric can be calculated as a percentage. That percentage difference can be applied as the economic obsolescence percentage measurement.

The difference between the "what you have" or the actual economic metric and the "what you want" or benchmark economic metric can also be converted into a dollar-based economic deficiency. That economic deficiency can be capitalized as an annuity in perpetuity in order to conclude an economic obsolescence dollar measurement.

Economic obsolescence can be measured as a deficiency in profit margin or as a deficiency in rate of return (including in the long-term growth rate component of return on investment).

The subject unit's profit margin deficiency can be influenced by any factors causing a deficiency in the unit-level profits (however measured) and a deficiency in the unit-level revenue (or in related utilization or inutility).

The subject unit's rate of return deficiency can be influenced by any factors causing a deficiency in the unit-level profits (however measured) and an excess in the unit level amount of (or the value of) investment (however measured).

The causes of (or the reasons for) the economic obsolescence should be external to the subject unit's real estate or tangible personal property. However, the causes of (or the reasons for) the economic obsolescence are not necessarily external to the subject unit business enterprise.

As a fundamental principle of both summation property appraisals and unit property appraisals, cost is not equal to value. Cost is not an indication of value. Rather, cost less all forms of depreciation provides an indication of value.

Economic obsolescence is not an adjustment from the unit value:

- Economic obsolescence is not subtracted from the unit value.
- Economic obsolescence is subtracted from the unit cost metric.
- Economic obsolescence is not an adjustment from a final cost approach value indication.
- Economic obsolescence is an adjustment in order to get to a final cost approach value indication.

The economic obsolescence measurement typically involves economic data and economic analyses. Experienced property appraisers are aware of the following observations:

- Income data are analyzed in all economic analyses.
- The analysis of income data does not convert the cost approach into the income approach.
- The economic analysis measurement can be developed when no income approach analysis is developed and no income approach value is concluded.

- The income approach—and the cost approach—and the market approach—all consider some measures of the subject unit's income data.

Economic Obsolescence Measurement Methods

There are several generally accepted economic obsolescence measurement methods, including the following:

- Market extraction method
- Matched pair sales comparison method
- Capitalization of income loss method
- Inutility method

The application of the market extraction method involves the following analytical procedures:

- The appraiser first identifies the sales of comparable properties
- The appraiser second compares each property sale price to the cost less physical depreciation for each comparable property
- If the sale price exceeds the cost less depreciation, then there is no economic obsolescence
- If the sale price is less than the cost less depreciation, then the deficiency is considered to indicate economic obsolescence
- The economic obsolescence can be divided by the comparable property's cost (or by the comparable property's cost less depreciation) metric in order to calculate an economic obsolescence percent
- This economic obsolescence measurement percentage can be applied to the cost metric for the subject unit property

The application of the matched pair sales comparison method involves the following analytical procedures:

- The appraiser first identifies matched pair properties for comparison
- The matched pairs can be either (1) two comparable properties that sold around the same time—one experiencing economic obsolescence and one not or (2) the same property that sold recently (experiencing economic obsolescence) and that sold years prior (before experiencing economic obsolescence)
- The matched pair sale pricing data are analyzed in order to calculate an economic obsolescence measurement percent
- This economic obsolescence measurement percentage can be applied to the cost metric of the subject unit property

The application of the capitalization of income loss method ("CILM") includes the following analytical procedures:

- The appraiser analyzes one or more property-specific income (profit margin or rate of return) metrics
- The appraiser selects corresponding benchmark (e.g., historical, projected, industry, comparable property) income metrics
- The appraiser calculates the difference between the property-specific actual income (margin or rate of return) metric and the benchmark income (margin or rate of return) metric
- The appraiser applies this difference in the income metrics (i.e., actual vs. benchmark) to the subject unit property (either as a percentage measure or as a capitalization of the income deficiency)

The inutility method of obsolescence measurement typically involves the application of the following formula:

$$\%\ inutility = \left[1 - \left(\frac{intended\ capacity}{actual\ capacity}\right)^{x}\right] \times 100$$

where:

Intended capacity = the property's design or rated production or utilization

Actual capacity = the property's actual production or utilization

x = scale factor exponent of the cost increase compared to the volume increase

This inutility obsolescence measurement method assumes that economic obsolescence is directly proportional to inutility (or to underutilization). This obsolescence measurement method assumes that all costs of the unit's production/utilization are variable. That is, there are no unit-level fixed costs. Therefore, the unit-level profit margin is assumed to remain constant (and adequate) at all property utilization levels.

The first two economic obsolescence measurement methods are more applicable to summation principle property appraisals.

The CILM measurement method is applicable to both summation principle property appraisals and unit principle property appraisals.

The inutility measurement method typically understates economic obsolescence. The inutility method measures the unit's deficiency in volume (production) but not the unit's deficiency in profit margins or rates of return.

Exhibit 3 summarizes and compares the relative strengths and weaknesses of the generally accepted economic obsolescence measurement methods.

All Cost Approach Methods Should Conclude about the Same Value

There should be one synthesized total unit value conclusion for the subject taxpayer property unit. There should be one synthesized unit value conclusion developed by the application of the cost approach.

All cost approach property appraisal methods should conclude mutually supported unit value indications. The different cost approach property appraisal methods should not conclude materially different unit value indications.

While cost metrics may vary between the various cost approach property appraisal methods, the depreciation measurement metrics should also vary between the cost approach property appraisal methods.

In particular, the economic obsolescence measurements should vary between the various cost approach property appraisal methods—and bring the various method unit-level value indications in line with each other.

This concept of offsetting cost metrics and offsetting depreciation/obsolescence metrics is illustrated in Exhibit 4.

The different cost approach property appraisal methods assume different benchmark units of operating property. These different benchmark units of property typically manifest different depreciation components.

Typically, the changes in the benchmark depreciation components approximately offset the changes in the benchmark cost metrics. Accordingly, alternative cost approach property appraisal methods should conclude generally comparable values for the same unit of operating property.

Capitalization of Income Loss Method Principles and Procedures

The application of the CILM quantifies the first principle of economic obsolescence measurement. That is, economic obsolescence considers the difference between:

1. the actual economic condition of the subject unit and
2. the required (or the market participants' opportunity return) economic condition of the subject unit.

The difference in the subject unit's actual economic condition versus required (i.e., market participant) economic condition can be measured by the following:

- Profit margins
- Returns on investment
- The individual components of either of these two margin or return financial fundamentals, including the following:
  - Price or volume changes for goods and services produced by the unit
  - Prices of materials, labor, or overhead consumed
  - Changes in capital asset or working capital investments
  - Changes in income tax rates
  - Changes in cost of capital components
  - Regulatory changes affecting the subject unit's operations

The difference in the subject unit's profit margin can be measured different ways through various income or cash flow components, including the following:

- Before or after tax
- Before or after debt service
- Before or after nonoperating expense
- Dollar revenue or per unit revenue
- Dollar expense or per unit expense
- Market size, market share, or market demand

The difference in the subject unit's return on investment can be measured different ways through various income, cash flow, or investment components, including the following:

- Return
  - Before or after tax
  - Before or after debt service
  - Before or after nonoperating expense
  - Any revenue or expense metric
  - Growth rate for any of the above return components
  - The cost of capital
- Investment
  - Gross tangible assets

Exhibit 3
Generally Accepted Economic Obsolescence Measurement Methods
Comparison of Application Strengths and Application Weaknesses

Measurement Method	Application Strengths	Application Weaknesses
Market extraction	• Market-based analysis is based on empirical transaction evidence	• For most unit appraisals, it is difficult to identify comparable unit sales • For most unit appraisals, it is difficult to measure the cost less depreciation of the comparable units
Matched pair sales comparison	• Market-based analysis is based on empirical transaction evidence	• For most unit appraisals, it is difficult to identify matched pair sales (specifically a subject unit matched pair sale) • It may be difficult to associate the before and after unit value decrease with economic obsolescence
CILM	• Actual profit margins and actual ROIs are based on empirical evidence • Required profit margins and return on investments are based on empirical evidence • Comparing the subject unit ROI to the subject unit cost of capital utilizes a perfect comparable	• It may be difficult to identify benchmarks for comparison • It may be difficult to identify benchmark time periods for comparison • At least one application of this method should be based on a return on (pre-economic obsolescence adjustment) cost approach value indication
Inutility	• Both actual and benchmark data are generally available at the subject unit • This "textbook" formula provides the appearance of precision	• The appraiser may have to justify the rated or design capacity as an achievable benchmark • Scale factor exponent data are not always available • This method can be associated with either functional obsolescence or economic obsolescence • The 100% variable cost assumption is usually not valid; so this method may understate the measurement of economic obsolescence • Unit product/service price decreases usually accompany unit product/service volume decreases; therefore, so profit margins and returns on investment typically decrease at a greater rate than does the utilization decrease.

Exhibit 4
Illustrative Example of How Depreciation Metric Changes May Often Offset Cost Metric Changes

	Cost Approach Valuation Variable	HCLD Method	RPCNLD Method	RCNLD Method
A	Cost metric	$1,200,000	$1,800,000	$1,500,000
B	Physical depreciation [1]	500,000	600,00	600,000
C	Functional obsolescence [2]	100,000	200,000	0
D	Cost less PD less FO (A – B – C = D)	600,000	1,000,000	900,000
E	Unit operating income	50,000	50,000	50,000
F	Actual unit ROI (E ÷ D)	8.3%	5%	5.6%
G	Required unit ROI (cost of capital) [3]	10%	10%	10%
H	Return deficiency (rounded) (G – F)	1.7%	5%	4.4%
I	Income deficiency (rounded) (H × D)	10,000	50,000	40,000
J	Capitalization rate [3] (= G)	10%	10%	10%
K	Capitalization of income loss (EO = I ÷ J)	100,000	500,000	400,000
L	Value indication (rounded) (D – K = value)	$500,000	$500,000	$500,000

EO = Economic obsolescence
FO = Functional obsolescence
HCLD = Historical cost less depreciation
PD = Physical depreciation
RPCNLD = Reproduction cost new less depreciation
RCNLD = Replacement cost new less depreciation
ROI = Return on investment
Notes:
[1] Effective age varies based on the benchmark cost metric.
[2] Functional obsolescence varies compared to the benchmark; the ideal replacement unit may have no functional obsolescence.
[3] Capitalization rate = the unit's cost of capital (assumes a 0 percent expected long-term growth rate as a simplifying assumption).

- Net tangible assets
- Current value of tangible assets
- Total assets
- The owners' equity
- Total invested capital (owners' equity plus long-term debt)

The benchmark for the subject unit's economic condition performance can be any benchmark that is not (or is less) influenced by economic obsolescence, including the following:

- Guideline public companies
- Specific competitor companies
- Industry trade association data
- The industry cost of capital metric
- The subject unit's cost of capital metric
- The subject unit's historical results of operations (before economic obsolescence impact)
- The subject unit's prospective results of operations (without economic obsolescence impact)
- Property owner management or industry expectations at the time of a subject unit investment

The benchmark level of economic performance can be any benchmark that is not (or is less) influenced by economic obsolescence, including the following:

- Mean, median, or other central tendency measures
- Top 25 percent or top 10 percent of the benchmark data array
- The highest data point in the benchmark data array (e.g., the top performing company or the best performance time period)

If the subject taxpayer's industry is generally impacted by economic obsolescence, then the use of mean or median benchmarks will typically understate the economic obsolescence measurement. This is because the mean or the median benchmark metrics themselves will be impacted by the existence of industry-wide economic obsolescence.

When economic obsolescence affects the benchmark metrics, then it may be appropriate to use the top performing data point (e.g., the top 10 percent or the top individual company) to measure the unit-level economic obsolescence.

This is because market participant investors will require the achievable economic metrics produced by the top performer in the taxpayer's industry—that is, the benchmark that is not (or is least) affected by the industry-wide economic obsolescence.

Simplified Illustrative Example of the Capitalization of Income Loss Method

This section provides a simplified illustrative example of the application of the capitalization of income loss method of economic obsolescence measurement.

There are numerous specific applications of the CILM, but they all involve some quantification of either a profit deficiency, a return deficiency, or some other measure (price decrease, cost increase, volume decrease, etc.) of income deficiency.

The CILM is a frequently applied economic obsolescence measurement method in a unit principle property appraisal developed for state and local tax planning, compliance, or controversy purposes.

In this illustrative example, let's assume that the appraiser's unit principle cost approach analysis concludes the following results:

Unit cost metric (however defined)	$200 million
– Physical deterioration	80 million
– Functional obsolescence	20 million
= Cost less PD less FO	$100 million

In this illustrative example, let's assume the following unit-level operating results:

Representative operating cash flow (may be the unit-level historical average or the unit's expected next period operating results)	$6 million

And, let's assume that the appraiser analyzes the following actual unit-level economic condition:

Representative operating cash flow	$6 million
÷ Unit cost less PD less FO investment	100 million
= Actual unit-level return on investment	6%

Now, let's assume the following required (or market-participant-derived) unit-level economic condition:

Unit weighted average cost of capital	12%
– Expected long-term growth rate in the selected income metric	2%
= CILM direct capitalization rate (i.e., the required income return on investment)	10%

Based on the above-listed hypothetical data, let's assume the following unit-level economic obsolescence measurement:

Required income return on investment (i.e., direct capitalization rate)	10%
– Actual unit-level return on investment	6%
= Rate of return on investment deficiency (i.e., income loss)	4%

Rate of return on investment deficiency	4%
÷ Required income return on investment (i.e., direct capitalization rate)	10%
= Economic obsolescence measurement percentage	40%

Using the same illustrative example data set, let's consider another application of the CILM. Let's assume an alternative economic obsolescence measurement as follows:

Unit cost less PD less FO	$100 million
× Required income return on investment (i.e., direct capitalization rate)	10%
= Required unit-level income metric	$10 million

Required unit-level income metric	$10 million
– Actual unit-level representative operating cash flow	6 million
= Income loss (i.e., required income – actual income = income loss)	$4 million

The following calculation presents one application of the CILM to quantify the subject unit's economic obsolescence measurement conclusion:

Unit cost less PD less FO	$100 million
× Economic obsolescence percentage	40%
= Economic obsolescence dollar measurement	$40 million

The following calculation presents an alternative application of the CILM to quantify the subject unit's economic obsolescence. This CILM application conclusion is presented below:

Income loss (i.e., required income – actual income = income loss)	$4 million
÷ Direct capitalization rate	10%
= Economic obsolescence dollar measurement	$40 million

Based on the cost data and the CILM economic obsolescence measurement calculations, we can conclude the unit principle property appraisal cost approach analysis. The illustrative example cost approach unit-level value conclusion is presented below:

Unit cost less PD less FO	$100 million
– Economic obsolescence dollar amount	40 million
= Cost approach unit-level value indication	$60 million

Top 10 Assessor Objections to Economic Obsolescence Measurements

Exhibit 5 presents many of the typical assessment authority objections to unit-level economic obsolescence measurements. These typical objections are not presented in any particular order of priority or importance.

These typical objections assume that the state or local assessment authority has been presented with the taxpayer's unit principle property appraisal of the subject industrial or commercial property. The taxpayer's unit principle appraisal includes a cost approach analysis. And, the cost approach analysis encompasses the identification and quantification of unit-level economic obsolescence with regard to the subject taxable property.

A discussion of each of these "top 10" typical objections—and a recommended best practices response to each objection—is presented next.

Economic Obsolescence Measurement Objection 1: The Cost Approach Becomes the Income Approach

Assessor Objection

Economic obsolescence converts the property appraisal cost approach into the income approach.

Best Practices Response

All property appraisal professional literature, professional standards, and professional guidance recognize three generally accepted property appraisal approaches:

- Cost approach
- Market approach
- Income approach

All unit principle property appraisal professional literature, professional standards, and professional guidance also recognize three generally accepted unit principle property appraisal approaches:

- Cost approach
- Market approach
- Income approach

All appraisal professional literature, professional standards, and professional guidance recognize three types of property appraisal depreciation within the application of the cost approach:

- Physical deterioration
- Functional obsolescence
- External (including economic) obsolescence

There is one economic obsolescence measurement method that does convert the cost approach into the income approach. That method is typically called the income shortfall method. For that reason, the income shortfall method is not considered a generally accepted economic obsolescence measurement method.

The income shortfall method is typically applied (or misapplied) as follows:

Step 1

A. Unit cost less PD less FO
– B. Income approach value indication
= C. Income shortfall

Exhibit 5
Top 10 Typical Assessor Objections to Economic Obsolescence Measurements

1. Economic obsolescence converts the cost approach into the income approach
2. The CILM does not rely on empirical data
3. The CILM is the income shortfall method
4. The selected CILM benchmarks are not achievable
5. The CILM is not the measurement method described in *The Appraisal of Real Estate* textbook
6. The appraiser needs to identify and quantify the specific causes of the economic obsolescence
7. Economic obsolescence was caused by management's bad decisions
8. Economic obsolescence is already captured in the income approach and the market approach
9. Economic obsolescence is caused by factors external to the subject taxing jurisdiction
10. The appraiser cannot associate the unit economic obsolescence with specific real estate or tangible personal property

Step 2

A. Unit cost less PD less FO
– C. Income shortfall
= D. Cost approach value indication

As indicated in the above illustrative application of the income shortfall method:

- the appraiser has to develop an income approach analysis and conclusion before completing the cost approach analysis and
- the income shortfall method always forces the cost approach unit value indication to exactly equal the income approach unit-value indication.

Neither the CILM nor any of the other generally accepted economic obsolescence measurement methods have the conceptual flaws of the income shortfall method.

In the application of the CILM, the cost approach analysis is independent of the income approach. In fact, the cost approach analysis can be concluded when no income approach analysis is ever developed.

It is true that all economic obsolescence analyses consider "economics." That is, all economic obsolescence measurements encompass some analysis of some unit-level income-related data.

All market approach analyses also consider some type of subject property income-related data (e.g., market-derived pricing multiple x subject property income metric). However, the consideration of some income-related data does not convert the cost approach—or the market approach—into the income approach.

Economic Obsolescence Measurement Objection 2: The CILM Is the Income Shortfall Method

Assessor Objection

The income shortfall method is not a generally accepted economic obsolescence measurement method. The CILM is a disguised application of the income short method.

Best Practices Response

The CILM is a generally accepted economic obsolescence measurement method. The CILM is described in the authoritative appraisal literature published by numerous valuation professional organizations, including the following:

- American Society of Appraisers
- Appraisal Institute
- American Institute of Certified Public Accountants
- International Association of Assessing Officers
- Other organizations

The income shortfall method is not a generally accepted economic obsolescence measurement method. The income shortfall method is not accepted in the appraisal professional literature, by valuation professional organization guidance, or in relevant judicial decisions.

The typical application of the income shortfall method is based on the difference between:

1. the income approach unit-level value indication and
2. the cost approach unit-level value indication (before the recognition of economic obsolescence).

The mathematical difference between these two unit-level value indications is the economic obsolescence measurement.

It is true that the income shortfall method results in the cost approach unit-level value being identical to the income approach unit-level value.

In contrast, the CILM is based on the difference between:

1. the unit's actual profit margin or return on investment metric (based on the cost approach pre-economic-obsolescence indication) and
2. the unit's required profit margin or return on investment metric (based on a market participant benchmark or opportunity return metric).

The CILM is not a residual measurement method. The CILM does not equate the cost approach unit-level value with the income approach unit-level value. The CILM can be developed independently from (and without ever developing) the income approach.

The CILM is not the income shortfall method.

Economic Obsolescence Measurement Objection 3: CILM Does Not Rely on Empirical Data

Assessor Objection

The application of the CILM does not rely on any market-derived transactional data to measure economic obsolescence.

Best Practices Response

Actually, the CILM does not rely on anything other than market-derived empirical data to measure economic obsolescence.

It is important to recall that the CILM compares:

1. the unit's actual economic condition to
2. the unit's required economic condition.

All data related to the unit's actual economic condition (e.g., profit margin or return on investment or any component there of—such as market share) are empirical data related to the subject unit's actual results of operations.

All data related to the unit's required economic condition are based on market participants' required (or opportunity) profit margin or return on investment economic condition.

These market participants' required margins or returns are derived from the following:

- Guideline company empirical evidence
- Selected most comparable company empirical evidence
- Taxpayer industry empirical data
- Subject unit's cost of capital empirical data
- Subject unit's historical performance empirical data
- Subject unit's prospective performance empirical data

It is true that unit property appraisers typically cannot extract required rates of return from the actual sales of comparable property units. This is because for special-purpose properties:

- few other property units would be sufficiently comparable to the subject unit,
- comparable property units rarely sell, and
- the comparable property units that do sell rarely disclose their unit-level operating income data.

Nonetheless, the data applied in the typical CILM analysis are all market-derived empirical data. This is because the profit margin or the return on investment data were actually earned by market participants who invested in actual guideline public companies, industry benchmark companies, or the subject taxpayer company.

Economic Obsolescence Measurement Objection 4: CILM Benchmarks Are Not Achievable

Assessor Objection

The benchmark rates of return (or other financial or operational metrics) used in the CILM analysis cannot be achieved by the subject unit.

Best Practices Response

The financial or operational benchmarks included in the CILM analysis are typically based on empirical data related to one or more of the following:

- Actual taxpayer unit or actual taxpayer industry cost of capital data
- Actual public company results of operations
- Actual taxpayer industry (e.g., trade association) results of operations
- Actual subject unit historical results of operations

The benchmark economic metrics are not the property owner's "wishful thinking." Rather, the owners or operators of industry participants (e.g., public competitors, private competitors, the subject unit) actually achieved the benchmark economic metrics. That is how the benchmark metrics became the benchmark metrics.

As of the valuation date, the subject unit may not be achieving the benchmark metrics. In fact, that income deficiency (compared to the benchmark) is the indication of economic obsolescence with regard to the subject unit.

However, market participants did earn the benchmark returns at alternative investment opportunities. Or, the subject taxpayer did previously earn the benchmark returns at the subject unit.

These benchmark returns represent the "opportunity return" on an alternative investment available to the market participants. Therefore, the market participants will price an investment in the subject unit (i.e., they will apply economic obsolescence to the subject unit cost metric) in order to earn that opportunity rate of return on the subject unit-level value.

The CILM benchmarks were achieved by some industry participants. That is how those margins or returns became the benchmark data. Therefore, market participants expect to earn the benchmark returns on an investment in the subject unit.

Economic Obsolescence Measurement Objection 5: The Unit Principle CILM Is Not Described in the *Appraisal of Real Estate* Textbook

Assessor Objection

The CILM applied in the unit principle property appraisal is not exactly the same methodology as illustrated in the *Appraisal of Real Estate* CILM examples.

Best Practices Response

The Appraisal of Real Estate textbook describes summation principle property appraisal procedures—not unit principle property appraisal procedures. *The Appraisal of Real Estate* CILM description considers a deficiency in a single property rental income (i.e., a deficiency compared to the current market comparable property rental income).

Unlike a single rental property subject to a summation principle appraisal, the subject unit does not generate rental income. Rather, the subject unit generates business operating income. In a unit principle property appraisal, the income loss, if any, would relate to business operating income.

The current market rental income (described in the *Appraisal of Real Estate*) corresponds to the level of business operating income required to generate a market-derived required rate of return.

Instead of the "market" in a summation principle appraisal being comparable rental properties, the "market" in a unit principle appraisal is the return offered to investors by benchmark public companies, by private company competitors (i.e., the taxpayer industry), or by the subject unit itself (historically).

The Appraisal of Real Estate CILM example measures any deficiency in the income earned by operating a single rental property. The unit principle CILM measures any deficiency in the income earned by operating the subject total unit of operating property.

The unit appraisal principle CILM is conceptually identical to the *Appraisal of Real Estate* summation appraisal principle (or single property) CILM. The unit principle CILM is supported by authoritative professional literature related to the unit principle of property appraisal.

Economic Obsolescence Measurement Objection 6: Quantify the Individual Causes for Economic Obsolescence

Assessor Objection

The appraiser must identify and quantify each individual cause of (or each individual reason for) the economic obsolescence.

Best Practices Response

First, there is no valuation professional organization standard, literature, credentialing course, or other guidance that requires—or even recommends—such a causation-identification procedure.

It is noteworthy that ALL professional guidance indicates that the generally accepted formula for the application of the cost approach is as follows:

Cost measure
– Physical deterioration
– Functional obsolescence
– Economic obsolescence
= Value indication

That is, NO professional guidance indicates that the generally accepted formula for the application of the cost approach is as follows:

Cost measure
– Physical deterioration
– Functional obsolescence
– Economic obsolescence from cause number 1
– Economic obsolescence from cause number 2
– Economic obsolescence from cause number 3
= Value indication

Second, property appraisers do not identify and quantify the individual causes for any other type of appraisal depreciation. For example, property appraisers do not associate specific physical deterioration penalties with individual physical defects at a subject property.

In any other property appraisal, appraisers do not assign responsibility for the following:

- Who was responsible for not maintaining the subject facility, thereby causing the leaking roof.
- Who was responsible for installing too heavy equipment, thereby causing the facility's cracked floor.
- Which lift truck operator ran into the side of the building, thereby causing the facility's slanted wall.
- Which heavy trucks drove to and from the plant, thereby causing cracks in the facility's driveway.

Instead, in any other property appraisal, the appraiser concludes total physical depreciation. For example, the physical depreciation analysis for the typical industrial or commercial property may conclude any of the following:

- The actual age of the subject property is 20 years.
- The effective (observed) age of the subject property is 30 years.
- The expected useful economic life ("UEL") of the subject property is 40 years.
- The subject property is in below-average condition for its age.
- The subject property is, therefore, 75 percent (i.e., 30-year effective age ÷ 40-year UEL) depreciated.

It is true that the property appraiser may note any subject property physical defects in the property appraisal report. But, the appraisal report does not assign responsibility for—or individual depreciation penalties to—individual depreciation "causes."

Second, related to the measurement of economic obsolescence in the unit principle appraisal, property appraisers are not required to identify and quantify the following:

- Which competitor was taking market share from the subject unit
- Which purchasing executive signed the unfavorable supply contract, causing increased raw materials costs to the subject unit
- Which financial executive signed the financing agreement, allowing for increased interest rates to the subject unit
- Which taxpayer executive decided to expand the plant capacity during a period that ultimately became an industry downturn

Third, a property appraisal (whether a summation principle appraisal or a unit principle appraisal) is not a blame game.

"[U]nit managers typically cannot control the outcomes of their investment or operational decisions."

A property appraisal concludes value, not responsibility, liability, or causation. These are legal concepts that may determine who should pay damages to a damaged party. These legal concepts are not appraisal concepts related to determining who or what caused the unit-level economic obsolescence.

Fourth, the economic obsolescence measurement itself identifies the economic causes for the obsolescence. Compared to the benchmark economic condition, the subject unit is actually experiencing the following:

- Decreased revenue (e.g., decreased price, volume, or market share)
- Increased operating or financing expenses
- Decreased profitability or growth rate
- Increased capital investment

These economic variables are the "cause" or the "explanation" for the subject unit-level economic obsolescence.

Economic Obsolescence Measurement Objection 7: Poor Management Causes Poor Performance

Assessor Objection

If economic obsolescence does exist at the subject unit, it was caused by the unit management's bad decision making.

Best Practices Response

The first inference of this common assessor objection is that the taxpayer management deliberately decreased the value of the unit property in order to decrease the property tax expense. The illogical conclusion of this objection is that the unit property owner would prefer to own a less profitable business operation than to pay property tax expense.

The second inference of this common assessor objection is that the unit property owner would allow incompetent management to continue to inefficiently operate the subject unit's business operations. Of course, the fact is that whether the unit is owned by a public company or a private company, the unit property owners will quickly replace incompetent managers with competent managers.

It is also noteworthy that all unit-level business decisions should be evaluated when they were made—not in hindsight.

It is easy for an assessor (or any other party) to look back years after the fact and second-guess the unit management's investment and operational decisions. But, of course, unit management decisions can only be evaluated in light of the known competitive and economic conditions that existed at the time that those management decisions were made.

Unit managers are not expected to make perfect investment or operational decisions every time. In defense of shareholder litigation claims, company directors are typically protected by what is called "the business judgment rule." In the case of unit principle appraisals, unit management decisions should be evaluated by reference to a similar business judgment rule.

It is also noteworthy that unit managers typically cannot control the outcomes of their investment or operational decisions.

In regulated industries, management decisions are strongly influenced by regulatory authorities. And, in nonregulated industries, the outcomes of management decisions are strongly influenced by competitors' actions, customer preferences, general economic conditions, and general capital market conditions.

All that said, so-called "bad" management decisions still result in economic obsolescence with respect to the unit property. Economic obsolescence is due to factors outside of the subject property—NOT outside of the subject property owner. A unit principle appraisal is a property appraisal—and NOT a property owner appraisal.

The decisions of the property owner management are external to the unit's physical property itself. If the reason for the unit's inadequate economic condition (e.g., profit margin, return on investment, growth rate) are not due to the age, condition, inadequacy, or superadequacy of the physical property, then the inadequate economic condition indicates the existence of unit-level economic obsolescence.

Economic Obsolescence Measurement Objection 8: Economic Obsolescence Is Already Considered in the Income Approach and the Market Approach

Assessor Objection

Any unit-level economic obsolescence is already captured in the income approach and the market approach

analyses. Therefore, economic obsolescence does not have to also be considered in the cost approach.

Best Practices Response

The cost approach is exactly where economic obsolescence should be considered. Like all forms of appraisal depreciation, economic obsolescence is specifically a cost approach concept.

It is true that a well-developed income approach analysis and market approach analysis will both implicitly consider the subject unit's economic obsolescence. However, the cost approach explicitly considers the subject unit's economic obsolescence. The cost approach is where all forms of appraisal depreciation—including economic obsolescence—are specifically identified and separately quantified.

Each property appraisal approach should be independent of each other property appraisal approach. Of course, there is only one set of financial and operational data regarding the subject unit. So, all appraisal approaches draw on a common data set regarding the subject property.

But each property appraisal approach should be calculated independently and completely from each other property appraisal approach.

Assigning a greater weight to income approach or market approach value indications in the valuation reconciliation does not correct an incomplete cost approach analysis.

Before any unit value indications are considered in the final value reconciliation, each property appraisal approach should be fully supported—and fully completed. And, each property appraisal approach should provide a completely developed—and credible—value indication for the subject unit property.

Economic Obsolescence Measurement Objection 9: Economic Obsolescence Causes Are External to the Taxing Jurisdiction

Assessor Objection

The factors that cause the subject unit to experience economic obsolescence are external to the subject taxing jurisdiction.

Best Practices Response

Assessment authorities sometimes believe that they are being "blamed" or "punished" for any economic or industry phenomena that are occurring outside of their taxing jurisdiction. However, a unit principle property appraisal is not the blame game.

No party is blamed for the existence of economic obsolescence—in the subject unit or in the subject industry. Economic obsolescence is typically caused by uncontrollable customer, competitor, capital market, microeconomic, and macroeconomic conditions.

Economic obsolescence is always caused by factors that are outside of (or external to) the subject unit property. Those factors may also be external to the state or local taxing jurisdiction.

Those factors that cause the subject unit's economic obsolescence may include environmental conditions, weather patterns, foreign and domestic supplier actions, foreign and domestic customer actions, foreign and domestic competitor actions, capital market conditions, government and regulatory actions, and so forth.

There is no appraisal principle that requires (or even implies) that unit property values can only be influenced by factors constrained by the town, county, or state in which the unit property is located.

Economic obsolescence is caused by factors that are external to the subject property—and not by factors that are external to the subject property AND internal to the subject taxing jurisdiction.

Assessment authorities are used to residential property values being influenced by Federal Reserve interest rate policy, national inflation and unemployment rates, and other economic factors that are external to the subject taxing jurisdiction.

Economic Obsolescence Measurement Objection 10: Unit Economic Obsolescence Cannot Be Isolated to the Property Located in the Taxing Jurisdiction

Assessor Objection

Economic obsolescence is a unit-wide value adjustment. Economic obsolescence is not measured or applied specifically to the local (i.e., within the taxing jurisdiction) real estate or tangible personal property.

Best Practices Response

The statement included in this common assessor objection is correct. In a unit principle property appraisal, economic obsolescence is typically measured on a total unit-level basis. It is typically not measured separately for

each individual taxing jurisdiction in which the subject taxpayer unit operates.

In a unit principle property appraisal, most of the valuation variables are measured on a total unit-level basis, including the following:

- Cost trend factors
- Average total life of each property category
- Functional obsolescence (e.g., any capitalized excess operating expense)
- Economic obsolescence (e.g., any CILM analysis variables)

If the valuation variables are measured separately for each individual property location, that analysis is not really a unit principle property appraisal. Rather, such an analysis is probably a summation principle property appraisal.

For taxpayer properties that are physically, functionally, and economically integrated, some valuation variables—such as economic obsolescence—have to be measured on a total unit-level basis.

Because of the integrated nature of the unit property components, all property located in all taxing jurisdictions typically experience the same level of economic obsolescence. And, that unit-level economic obsolescence adjustment is typically measured as a percentage adjustment to any cost approach value indication.

It is inconsistent with the unit principle of property appraisal—and inconsistent with the integrated nature of the operations of the subject unit property—to assign a different economic obsolescence percentage to properties located in each individual taxing jurisdiction.

All integrated property units contribute to the subject unit's economic obsolescence condition. All integrated property units experience the same influence of the unit-level economic obsolescence. So, for a physically, functionally, and economically integrated unit, all property units are typically assigned some pro rata economic obsolescence adjustment.

Other Assessor Objections to Economic Obsolescence Measurements

The next section of this discussion summarizes other typical assessment authority objections to economic obsolescence measurements. These objections are not quite as common as the previously listed assessor objections. However, these objections are still raised fairly often. And, appraisers (and taxpayer property owners) should be aware that there are also best practices responses to these typical assessor objections.

Exhibit 6 presents a list of these other common assessor objections to economic obsolescence measurements. Each of these other assessor objections are described (and responded to) in the following section.

Economic Obsolescence Measurement Objection 11: Economic Obsolescence Measurements Change Materially over Time

Assessor Objection

The subject unit's economic obsolescence measurement can change materially from one year to the next year.

Best Practices Response

The statement included in this common objection is correct. Property values—including unit property values—can change from year to year.

Most unit principle property appraisals involve income-producing, special-purpose properties. The income generated by the subject unit may change from year to year, so the unit's actual economic returns may fluctuate over time. Economic and capital market conditions may also change from year to year. Therefore, the unit's required economic returns may fluctuate over time.

The difference between the subject unit's actual returns and the market participants' required returns may change from year to year. Therefore, the unit-level economic obsolescence may fluctuate over time.

Assessment authorities often experience fluctuations in property values due to economic obsolescence. For example, residential property values change (inversely) over time due to changes in mortgage interest rates.

Like homeowners, unit property owners may decide not to sell their property during the periods when property values are depressed. However, the owner's decision not to sell the property does not invalidate the fact that the property value (whether residential property or unit property) is depressed.

The objective of the unit principle property appraisal (or of any property appraisal) is to estimate a current property value—and not a constant property value over time.

Exhibit 6
Other Typical Assessor Objections to Economic Obsolescence Measurements

1. The economic obsolescence measurement can change materially from year to year.
2. If there was economic obsolescence, the taxpayer should record a GAAP accounting impairment charge.
3. If there was economic obsolescence, the taxpayer should disclose that fact to shareholders/others.
4. The appraiser can't subtract economic obsolescence in an HCLD method analysis.
5. There can be no economic obsolescence if the unit or the industry market value/book value ratio exceeds one.
6. The appraiser double-counted functional obsolescence and economic obsolescence.
7. Industry-wide economic obsolescence should not result I a taxpayer-specific value adjustment.
8. Economic obsolescence is temporary—or cyclical.
9. Investors expect economic obsolescence in certain industries so the appraisal should not adjust for that factor.
10. Investors expect the subject unit to underperform, therefore, the appraisal should not adjust for economic obsolescence.

Economic Obsolescence Measurement Objection 12: There Is No Economic Obsolescence without a GAAP Impairment Charge

Assessor Objection

If the taxpayer's property actually experienced economic obsolescence, then the taxpayer would have to record an impairment charge "write-down" on its generally accepted accounting principles ("GAAP") basis financial statements.

Best Practices Response

There are very specific accounting tests required for determining the impairment of a long-lived asset under U.S. GAAP. The guidance for such an asset impairment is provided by Financial Accounting Standards Board Accounting Standards Codification ("ASC") topic 360, *Property, Plant, and Equipment*.

Specifically, the asset impairment accounting guidance is provided in ASC topic 360-10, *Impairment or Disposal of Long-Lived Assets*.

ASC topic 360-10 provides for a very specific quantitative test for an asset impairment:

- If the sum of future cash flow over the asset's remaining useful life equals or exceeds the asset's net book value ("NBV"), then an asset impairment is not permitted.
- If the sum of the future cash flow over the asset's remaining life is less than the asset's NBV, then an asset impairment is required.

The taxpayer property owner cannot elect to take an asset impairment charge under U.S. GAAP. Either an asset impairment is required by ASC topic 360 or it is prohibited by ASC topic 360.

There is no provision in ASC topic 360-10, or in any other U.S. GAAP, for any consideration of economic obsolescence.

To illustrate the application of ASC topic 360-10, let's consider a simplified example. Our ASC topic 360-10 simplified illustrative example assumptions are as follows:

- Subject property NBV = $10,000,000
- Subject property remaining useful life = 10 years
- Subject property annual cash flow = $1,000,000

The ASC topic 360-10 long-lived asset impairment test would be developed as follows:

- Sum of cash flow over the asset's remaining useful life – $10,000,000
- Subject property NBV – $10,000,000
- Conclusion: An asset impairment is not allowed
- Property's actual internal rate of return (i.e., return on investment over the property's remaining useful life) – 0%

Now, let's consider the economic obsolescence implications of the same illustrative data set. Any positive market-derived required return on investment percent compared to a 0 percent property actual internal rate of return would indicate a substantial amount of property economic obsolescence.

Under the provisions of ASC topic 360-10, an asset impairment is not allowed until the property's actual

internal rate of return is negative (not less than the property's required rate of return—but actually negative).

Let's consider the following fundamental conceptual differences between (1) an economic obsolescence measurement and (2) the GAAP asset impairment test.

The economic obsolescence benchmark is (1) a market-required rate of return compared to (2) the incomplete (pre-economic obsolescence) cost approach metric. In contrast, the asset impairment benchmark is (1) the undiscounted cash flow generated by the asset compared to (2) the NBV of the asset.

Accountants appreciate that the ASC topic 360-10 asset impairment test is intended to be extremely difficult to "fail." This GAAP asset impairment test is intended to be difficult to "fail" for the following reasons:

- An asset impairment is permanent.
- An asset impairment (or "write-down") cannot be reversed.
- An impaired asset value cannot be "written up" when the subject property economic conditions improve.

In contrast to the GAAP asset impairment test, a unit-level value will increase in the future when the subject unit's economic conditions improve (and the subject unit's economic obsolescence decreases).

It is important for the appraiser and the taxpayer property owner to understand that there is absolutely no relationship between (1) the ASC topic 360-10 asset impairment accounting and (2) the recognition of economic obsolescence in a cost approach property approval.

It is also noteworthy that there is also no provision in ASC topic 360-10 for the asset owner to explain any of the reasons for—or any of the causes of—an asset impairment.

Economic Obsolescence Measurement Objection 13: The Property Owner Should Make a Public Disclosure of Economic Obsolescence

Assessor Objection

If the subject unit really experienced economic obsolescence, then the taxpayer property owner would have to publicly disclose that obsolescence.

Best Practices Response

There is no Financial Accounting Standard Board U.S. GAAP requirement to disclose economic obsolescence.

There is no International Accounting Standards Board international (or IFRS) GAAP requirement to disclose economic obsolescence.

There is no Securities and Exchange Commission requirement to disclose economic obsolescence.

There is no New York Stock Exchange requirement to disclose economic obsolescence.

There is no Nasdaq requirement to disclose economic obsolescence.

There is no Internal Revenue Service requirement to disclose economic obsolescence.

There is simply no requirement for a taxpayer property owner to disclose the existence of unit-level economic obsolescence to anyone.

Economic Obsolescence Measurement Objection 14: The Appraiser Cannot "Subtract" Economic Obsolescence from HCLD

Assessor Objection

It is not appropriate for an appraiser to "subtract" economic obsolescence in a historical cost less depreciation ("HCLD") method cost approach analysis.

Best Practices Response

First, economic obsolescence is not a "subtraction" from any cost measurement. Like all other types of appraisal depreciation, economic obsolescence is an adjustment from a preliminary cost approach metric indication that is applied in order to conclude a value indication.

Second, the cost approach HCLD appraisal method is not the same as accounting net book value. It is a correct statement that a GAAP accounting net book value figure does not recognize the existence of unit-level economic obsolescence. Rather, accounting NBV only considers accounting depreciation.

In contrast to accounting NBV, the HCLD property appraisal method is based on (1) the unit-level historical cost (or original cost, if available) less (2) all forms of appraisal depreciation.

In any cost approach analysis, appraisal depreciation includes the following three components:

- Physical deterioration
- Functional obsolescence
- External obsolescence (including economic obsolescence)

Typically, total appraisal depreciation does not equal total accounting depreciation. This is because accounting depreciation is intended to systematically allocate the cost of a property investment over the expected useful economic life of the property. Typically, accounting depreciation is not intended to indicate or even approximate a current market value for a property.

Some regulated industry entities have to apply regulatory accounting principles (including what are often called regulatory depreciation principles) for certain compliance purposes.

These regulated industry entities can elect to apply regulatory accounting principles as their GAAP accounting principles under the provisions of Financial Accounting Standards Board ASC topic 980, *Regulated Operations*. In such instances, the regulatory accounting depreciation becomes the financial accounting depreciation for those regulated entities.

The HCLD method of the cost approach to property appraisal is summarized as follows:

Historical cost
– Appraisal (including regulatory) depreciation
= Value indication

That is, the HCLD method of the cost approach to property appraisal is NOT summarized as follows:

Historical cost
– Financial accounting depreciation
= Value indication

There is no generally accepted valuation professional organization appraisal literature, appraisal standard, appraisal credentialing course, or other professional appraisal guidance that states that economic obsolescence should not be considered in the application of the HCLD property appraisal method.

Economic Obsolescence Measurement Objection 15: There Can Be No Economic Obsolescence If the Market Value/Book Value Ratio Exceeds One

Assessor Objection

The only appropriate test for economic obsolescence is the so-called market value/book value ratio. If that ratio exceeds 1, then there is no unit-level economic obsolescence.

Best Practices Response

Some assessors calculate a market value to book value ratio based on the taxpayer's stockholders' equity only. Some assessors calculate a market value to book value ratio based on the taxpayer's total invested capital (i.e., long-term debt plus stockholders' equity). In either case, the data that these assessors use to calculate the market value/book value ratio are selected guideline publicly traded companies.

This market value/book value ratio comparison assumes that all market value—and any market value price premium over book value—relates entirely to the tangible property recorded on the public company's GAAP balance sheet. However, there are numerous reasons why a public company's market value of equity (or of total invested capital) can be greater than the company's book value of tangible property.

In addition to the value of real estate and tangible personal property, a public company's market value of equity (or of total invested capital) encompasses the value of the following:

- Working capital accounts
- Identifiable intangible assets
- Intangible value in the nature of goodwill
- Present value of growth opportunities
- Intangible investment (public security) attributes

The meaningless (from a property appraisal perspective) nature of the market value/book value ratio comparison is illustrated by the simplified example presented in Exhibit 7.

This simplified example considers an illustrative public company taxpayer. This example assumes that both the book value and the market value of the company's long-term debt is $500.

This example assumes that the book value of the company's stockholders' equity is $700 and that the market value of the company's stockholders' equity (based on the public stock price) is $1,100. This hypothetical public company's market value to book value ratio is analyzed in the following calculations.

The market value/book value ratio indicated from the previous example is calculated below:

Exhibit 7
Taxpayer Company
Comparison of Book Value Balance Sheet to Market Value Balance Sheet

Taxpayer Company
Book Value Balance Sheet
As of the Valuation Date

Assets		Liabilities & Equity	
Current assets	$400	Current liabilities	$200
Plant, property, equipment	1,000	Long-term debt	500
		Stockholders' equity	700
Total	$1,400	Total	$1,400

Taxpayer Company
Market Value Balance Sheet
As of the Valuation Date

Assets		Liabilities & Equity	
Current assets	$400	Current liabilities	$200
Plant, property, equipment	800	Long-term debt	500
Intangible personal property	400	Stockholders' equity	1,100
Goodwill and PVGO	200		
Total	$1,800	Total	$1,800

- Market value/book value ratio based on TIC (i.e., the LTD & the SE) = 1.3x
  - ($1,600 ÷ $1,200) = 1.3x
- Market value/book value ratio based on stockholders' equity only = 1.7x
  - ($1,100 ÷ $700) = 1.7x

Let's assume that an appraiser conducted a fair market value valuation of all of the taxpayer company's tangible assets and intangible assets in order to allocate the market value of invested capital. This fair market value appraisal is the basis for the Exhibit 7 market value balance sheet for Taxpayer Company.

In contrast to the incorrect conclusion implied by the above market value/book value ratio calculations, the actual unit-level economic obsolescence implied by the Exhibit 7 data set example is presented below:

Book value of the plant, property, equipment (only)	$1,000
– Market value of the plant, property, equipment	800
= Market value decrement (below book value) in plant, property, and equipment	$200
= Implied economic obsolescence percentage (i.e., $200 ÷ $1,000)	20%

The above simplified example illustrates that the taxpayer company (or taxpayer industry) market value/book value ratio is a meaningless measure of unit-level economic obsolescence. This ratio is meaningless because the market value/book value ratio ignores all of the other influences on the market value of a public company's securities—other than the value of the company's tangible property.

Economic Obsolescence Measurement Objection 16: The Appraiser Double-Counted Functional Obsolescence and Economic Obsolescence

Assessor Objection

The unit-level economic obsolescence measurement is already captured in the appraiser's functional obsolescence adjustment.

Best Practices Response

Functional obsolescence and economic obsolescence are two different types of cost approach adjustments. However, both types of obsolescence adjustments may be influenced by these two property conditions:

1. The property is earning less income than its benchmark level of profit or return
2. The property has too much investment compared to its benchmark level.

Functional obsolescence is caused by factors internal to the subject unit property, including inadequacy and superadequacy.

Functional obsolescence is caused by factors directly associated with the unit's tangible property, including the following:

- Changes in technology (e.g., a new property is more efficient)
- Changes in construction or component material (e.g., a new property would be made from different material)
- Changes in size (e.g., too much or too little)
- Changes in location (e.g., too close or too far away)

Functional obsolescence is often measured by reference to:

1. capitalized excess operating expenses (compared to a benchmark property) and
2. excess capital costs (compared to a benchmark property).

Functional obsolescence is sometimes curable. For example, the ideal replacement property would be smaller (or larger), be made of different material, have a different fuel or raw material source, have a different layout or configuration, and have more efficient equipment or amenities.

Some functional obsolescence is not curable. For example, there may be physical constraints that prohibit the construction and operation of the ideal replacement property.

Economic obsolescence is caused by factors that are external to the subject unit's tangible property, including the following:

- Actions of competition
- Consumer demand and preferences
- Changes in the price of material, labor, and overhead
- Weather and climate changes
- Government and regulatory actions
- Capital market returns and interest rates
- Property owner responses to the above factors

Therefore, economic obsolescence is generally considered to be incurable. Appraisers should be careful to distinguish between (1) value decrements caused by functional obsolescence (internal factors) and (2) value decrements caused by economic obsolescence (external factors).

For example, let's assume that an electric generation plant is experiencing excess fuel costs (compared to a benchmark level). The appraiser should consider the following:

- Are the excess fuel costs caused by excess fuel consumption due to an inefficient heat rate (i.e., fuel consumed per kilowatt of electricity produced) compared to a modern plant—that is, due to functional obsolescence?
- Or, are the excess fuel costs caused by increased natural gas prices that are due to general industry conditions or an unfavorable supply contract—that is, due to economic obsolescence?

The appraiser should be careful to not consider the same cause of excess operating expenses (low income metric) and excess capital costs (high investment metric) in both the functional obsolescence measurement and the economic obsolescence measurement.

Economic Obsolescence Measurement Objection 17: Industry-Wide Economic Obsolescence Should Not Result in a Taxpayer-Specific Value Adjustment

Assessor Objection

If there is industry-wide economic obsolescence, then industry participants expect lower returns and the subject unit value should not be adjusted.

Best Practices Response

If the economic obsolescence is industry-wide (e.g., decreased prices for goods or services produced, increased prices for raw materials consumed), then every industry property owner is experiencing some amount of economic obsolescence.

Economic obsolescence is NOT measured as the difference between:

1. the subject property inadequate return on investment and
2. the subject industry inadequate return on investment.

The subject industry's (and the subject property's) required return on investment is measured without (or before) the adjustment for economic obsolescence.

If there is industry-wide economic obsolescence, then investors will downward adjust the prices for all industry properties until the investors are earning their required rate of return. Assessors are used to dealing with industry-wide economic obsolescence.

When mortgage interest rates increase nationwide, then all residential property values typically decrease.

Assessors cannot disregard this general residential property value decrease simply because it is affecting all residential real estate.

Economic Obsolescence Measurement Objection 18: Economic Obsolescence Is Temporary—or Cyclical

Assessor Objection

If it exists, the unit's economic obsolescence is temporary—or cyclical. It will resolve itself over time when the industry cycle turns up.

Best Practices Response

The unit's economic obsolescence measurement may, in fact, be temporary or cyclical. The economic obsolescence measurement may increase or decrease materially from year to year based on:

1. changes in the unit's actual financial performance over time and
2. changes in the market participants' required return on investment over time.

This cyclical nature of the measurement is further proof of the fact that economic obsolescence is external to the subject unit property.

However, in periods when economic obsolescence exists, it affects the unit property value. During those periods, the unit property value is decreased, and that value decrease should be reflected in the property tax assessment.

Also, in periods when economic obsolescence does not exist, it does not affect (or it little affects) the unit property value. During those periods, the unit property value is not decreased, and that fulsome value should be reflected in the property tax assessment.

Typically, property owner/taxpayers do not appeal the unit property assessment during periods when there is little or no economic obsolescence. Accordingly, the assessment authority should recognize an appropriate unit property value adjustment during periods when there is a material amount of economic obsolescence.

Assessment authorities experience the cyclical nature of economic obsolescence in residential real estate assessments. The impact of the COVID-19 pandemic caused home prices to increase for several years. The impact of increased mortgage interest rates has caused home prices to decrease recently.

The same type of cyclical external factors that affect the value of residential property also affects the value of industrial and commercial unit property—sometimes to an even greater degree.

Economic Obsolescence Measurement Objection 19: Investors Expect Economic Obsolescence in Certain Industries so the Appraisal Should Not Adjust for that Factor

Assessor Objection

Due to regulatory lag or historical subject industry performance, investors expect low rates of return. Therefore, the unit principle appraisal should not adjust for such below-market-expectations economic obsolescence.

Best Practices Response

The benchmarks applied in economic obsolescence measurements should be based on market-derived, empirical data. These benchmarks may be prices, volumes, costs, profit margins, returns on investment, and other metrics.

The empirical data considered in the measurement may relate to guideline public companies, trade association and other industry sources, the subject unit's historical results of operations, the subject unit's cost of capital, and other market participant sources.

The point is the benchmarks applied in economic obsolescence measurements are metrics that investors actually expect. This is because they are metrics that investors can actually achieve. This benchmark represents the opportunity returns actually available to market participant investors.

The market participant investors will either (1) invest in the benchmark investments—and earn the opportunity rate of return—or (2) invest in the subject unit—at a price that will allow them to still earn the opportunity rate of return.

If the market participants invest in the subject unit, they will only do so at a price that will yield to them the otherwise available opportunity rate of return. The difference between that price (i.e., a price that yields the opportunity return) and the unit's cost metric is called economic obsolescence.

So, if industry returns are consistently low, then market participants incorporate those low returns into their assessment of opportunity returns. But if some industry participants (e.g., guideline public companies or industry competitors) are earning higher returns, then market participants will incorporate those higher returns into their assessment of opportunity returns.

Therefore, the benchmark returns (and the opportunity returns) will be influenced by regulatory lag or by any other external factors causing the economic obsolescence.

If the subject unit's returns are less than the benchmark (or opportunity) returns, the appraisal does have to adjust the cost approach value indication for economic obsolescence. All investor expectations are fully incorporated into the benchmark (or opportunity) rates of return.

If the subject unit cannot generate that benchmark rate of return, then the market participants will reduce the bid price (i.e., the value) of the subject unit until the unit price yields that benchmark (or opportunity) return on investment.

Economic Obsolescence Measurement Objection 20: Investors Expect the Subject Unit to Underperform, so the Appraisal Should Not Adjust for Economic Obsolescence

Assessor Objection

The subject unit consistently underperforms the benchmark financial or operational metrics. Investors expect the subject unit to underperform. Therefore, the unit principle appraisal should not account for economic obsolescence.

Best Practices Response

The subject unit may have underperformed the benchmark financial or operational metrics for the last five years. The subject unit may be expected to underperform the benchmark financial or operational metrics for the next five years.

These facts do not indicate that there is no economic obsolescence associated with the subject unit. Instead, these facts actually indicate that there is consistent economic obsolescence at the subject unit.

For example, if the subject unit consistently does not earn its cost of capital, that fact does not imply that the cost of capital is too high. Rather, that fact does imply that the unit's actual return on investment is too low—and should be reflected in an economic obsolescence measurement.

Market participants look to the market for their opportunity benchmark metrics. Market participants can earn those market-derived opportunity returns elsewhere. So, market participants also expect to earn those market-derived opportunity returns at the subject unit.

If the subject unit consistently underperforms the required metrics, market participants will bid down the price of the subject unit. Market participants will continue to bid down the unit price until the participants can earn the opportunity rate of return on an investment in the subject unit.

This "bid down" price becomes the value of the subject unit. And, the difference between the subject unit's market value and the subject unit's cost metric is called economic obsolescence.

If the subject unit consistently underperforms the market's required return on investment metric, then the subject unit will consistently experience economic obsolescence. The market's required return on investment becomes the subject unit's cost of capital (or required rate of return). That market-derived cost of capital is not reduced because of the subject unit's historical (or expected) underperformance.

Assessment Authority Considerations regarding Economic Obsolescence

Both taxpayer property owners and property appraisers should be aware of certain economic obsolescence considerations that are sometimes expressed by assessment authorities. Some of these assessor considerations regarding economic obsolescence measurements are listed in Exhibit 8.

Taxpayer property owners and property appraisers should be aware of these possible assessor considerations when they are presenting their economic obsolescence "case" to the assessment authority.

Summary and Conclusion

A unit principle property appraisal is different from a summation principle property appraisal. A unit principle property appraisal is different from a business appraisal.

Cost (however measured) does not equal property value. Rather, cost (however measured) minus all types of appraisal depreciation indicates property value.

Exhibit 8
Typical Assessment Authority Considerations regarding Economic Obsolescence Measurements

1. If the assessor cannot "see" the economic obsolescence, then it is easy to reject the very concept of economic obsolescence.
2. Assessors often enjoy a statutory presumption of correctness, so taxpayers have to overcome this presumption in their proof of economic obsolescence measurements.
3. Assessors may apply a higher burden of proof on taxpayers regarding the measurement of economic obsolescence—compared to the measurement of physical depreciation or of functional obsolescence.
4. Assessors may believe that any (and every) economic obsolescence analysis is an income shortfall method—a method that effectively converts the cost approach into the income approach.
5. Assessors may believe if they "give" an economic obsolescence adjustment to one taxpayer, then all taxpayers will claim that they deserve an economic obsolescence adjustment.
6. Assessors may not understand why any taxpayer would continue to make capital expenditures (or to consummate an acquisition) if the subject unit is experiencing economic obsolescence.
7. Assessors may not understand why any investor would invest in a taxpayer company—or in a taxpayer industry—that is experiencing economic obsolescence.
8. Assessor may believe that any unit that is growing or expanding in any way cannot be experiencing economic obsolescence.
9. Assessors may believe that any unit that is experiencing any positive profits or any positive return on investment cannot be experiencing economic obsolescence.
10. Assessors may believe that any unit (or any taxpayer industry) that has a business value greater than its tangible property book value cannot be experiencing economic obsolescence.

Economic obsolescence is not a "subtraction" from the cost approach value indication. Rather, economic obsolescence is an "adjustment" that is necessary in order to get to the cost approach value indication.

The measurement of economic obsolescence typically does consider some income-related metrics. However, that consideration does not convert the cost approach into the income approach. It is noteworthy that the market approach also considers income-related metrics.

Economic obsolescence is typically measured on a comparative basis. Unit-level economic obsolescence measurements typically compare the unit level economic condition of "what you have" to the unit-level economic condition of "what you want."

The unit-level economic condition you "want" does not mean the economic condition that the taxpayer property owner desires or would like to have. Rather, the unit-level economic condition you "want" means the economic returns that market participants "require" to induce them to invest in the subject unit.

The benchmarks for economic obsolescence measurements are market-derived empirical returns that are actually earned by guideline companies, other industry participants, and the subject unit (historically).

The benchmark returns considered in the economic obsolescence measurement are the opportunity returns actually available to investors or market participants in the subject industry.

The CILM is one generally accepted economic obsolescence measurement method. The CILM is not the income shortfall method. And, the CILM is not the income approach.

There is typically not one industry-wide measure of economic obsolescence. And, there is typically not one company or taxpayer measure of economic obsolescence. Rather, economic obsolescence is applied within the context of each individual unit-level cost approach analysis.

That is, the economic obsolescence measurement is specific to the subject appraisal cost metric. For example, a unit appraisal based on a $10 million cost metric will have a different economic obsolescence adjustment than an appraisal of the same unit that is based on a $50 million cost metric.

In other words, the greater the cost metric, the lower the cost-based unit-level return on investment—and the greater the unit-level economic obsolescence adjustment.

Appraisers and taxpayer property owners should be aware that there are best practices responses available to address many of the typical assessment authority objections related to economic obsolescence measurements.

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Robert Reilly is a managing director in our Chicago practice office. He can be reached at (773) 399-4318 or at rfreilly@willamette.com.

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111 S.W. Fifth Avenue
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Portland, OR 97204
503 • 222 • 0577

8600 W. Bryn Mawr Avenue
Suite 950-N
Chicago, IL 60631
773 • 399 • 4300

1355 Peachtree Street, NE
Suite 1470
Atlanta, GA 30309
404 • 475 • 2300

Best Practices for Developing and Reporting Fair Value Measurements

Robert F. Reilly, CPA

Fair value measurements are developed for numerous financial-accounting-related purposes. This discussion summarizes valuation analyst ("analyst") best practices related to the development and the reporting of such fair value measurements. These best practices are intended to assist analysts to avoid the more typical errors and omissions related to such financial-accounting-related assignments. This discussion focuses on fair value measurements developed in compliance with Financial Accounting Standards Board Accounting Standards Codification topic 805, ***Business Combinations***. However, most of the recommended analyst best practices also apply to fair value measurements developed for many financial accounting purposes.

Introduction

First, this discussion reviews the first principles related to fair value measurements developed for U.S. generally accepted accounting principles ("GAAP") compliance purposes.

Second, this discussion summarizes best practices for valuation analysts ("analysts") who are developing and reporting fair value measurements. In particular, this discussion recommends analyst best practices for avoiding the top 10 most common analyst fair value measurement errors and omissions.

Third, this discussion recommends analyst best practices for handling other (but still common) fair value measurement issues.

Finally, this discussion presents analyst caveats and recommends reporting best practices related to valuation analyses prepared for various financial accounting purposes.

This discussion focuses on best practices related to fair value measurements developed with regard to the allocation of a business combination transaction purchase price. However, many of the best practices recommended also apply to fair value measurements developed for other financial accounting purposes.

Fair Value Measurement First Principles

The Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") topic 820, *Fair Value Measurement*, defines the term fair value as follows: "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

This ASC topic 820 fair value definition includes several important analyst considerations with regard to the hypothetical fair value transaction. The requirements for such a fair value transaction include the following:

- An orderly transaction
- A transaction between market participants
- A transaction in the principal or the most advantageous market
- A transaction value indicating an exit price

ASC topic 820 provides rules-based guidance to both analysts and accountants with regard to the following fair value measurement considerations:

- Valuation principles and methodologies

- Valuation techniques
- A hierarchy of valuation analysis inputs

When Do Fair Value Measurements Apply?

The following ASC topics provide professional guidance for both analysts and accountants with regard to transactions and/or events in which fair value measurements apply:

- ASC 718 – share-based payments
- ASC 410 and 440 – asset retirement obligations
- ASC 805 – business combinations
- ASC 460 – guaranties
- ASC 845 and 605 – nonmonetary transactions
- ASC 420 – restructuring obligations
- ASC 852 – reorganization "fresh start accounting"
- ASC 350 – goodwill impairment
- ASC 360 – long-lived asset impairment
- ASC 320 – investments – debt and equity securities
- ASC 321 – investments – equity securities

This discussion focuses on fair value measurements developed and reported with regard to ASC 805 topic, *Business Combinations*. That is, these best practices relate to fair value measurements developed for allocation of purchase price purposes within the context of a business combination.

Nonetheless, many of the best practices recommended in this discussion also apply to fair value measurements developed for other financial accounting purposes.

When Do Fair Market Value Valuations Apply?

This discussion focuses on fair value measurements developed for financial accounting compliance purposes. To better understand fair value measurements, it may be helpful to contrast fair value measurements with fair market value valuations.

Fair market value valuations are developed for numerous nonfinancial accounting purposes, including the following:

- Federal income tax compliance
- Federal gift and estate tax compliance
- Bankruptcy
- Financings
- Transaction structurings
- Commercial contracts
- Other

Fair market value valuations are typically developed when the purpose of the analysis is to emulate the negotiation considerations of a willing buyer and a willing seller.

Differences between Fair Value Measurements and Fair Market Value Valuations

Fair value measurements (developed for financial accounting compliance purposes) and fair market value valuations (developed for other purposes) have numerous conceptual and practical differences. Both analysts and accountants should be aware of these differences.

A fair value measurement is a rules-based analysis, with the analysis rules provided primarily by ASC topic 820. Fair value measurements apply in many financial accounting compliance situations.

In contrast, a fair market value valuation is a judgment-based analysis. Applying independent professional judgment regarding valuation approaches, methods, and procedures, an independent appraiser attempts to emulate a market transaction in the development of the fair market value valuation.

Fair market value valuations often apply in transactional situations—but they do not typically apply in financial accounting compliance situations.

Discussion Definitions

For purposes of this discussion, let's apply the definition presented below.

The term "analyst" means any valuation specialist in any property appraisal discipline (including business, real estate, tangible personal property, and intangible personal property).

The term "principal analyst" is the individual with overall responsibility for the allocation of purchase price fair value measurement engagement team.

The term "best practices" represents the general consensus regarding current valuation profession practices and procedures—"best practices" does not imply either valuation professional standards generally or allocation of purchase price engagement requirements specifically.

Top 10 Best Practices for Developing and Reporting Fair Value Measurements

This discussion section presents 10 recommendations for analysts who are developing fair value measurements for financial accounting purposes.

For the most part, these best practices assume a fair value measurement developed for ASC topic 805 compliance purposes. However, most of these recommended analyst best practices would also apply to fair value measurements developed for other financial accounting purpose.

Best Practice Number 1: Review the Transaction Documents

As a best practice, the analyst should review the stock purchase agreement or the asset purchase agreement related to the subject business combination transaction.

The allocation of purchase price should be consistent with the subject transaction documents—and with the transaction document's intent. In particular, the analyst should be aware of how the following topics are described in the asset purchase or stock purchase transaction documents:

- Assets and liabilities included in the transaction
- Assets and liabilities excluded in the transaction
- Assets and liabilities emphasized in the document
- Asset and liability balances (minimum or maximum) stated in the document

The analyst should understand that he or she is valuing the acquired assets and liabilities within the context of a specifically negotiated—and carefully documented—business combination transaction.

Best Practice Number 2: At-Market Contracts May Have Intangible Asset Value

Under the guidance provided by ASC topic 805, a fair value measurement value is typically only assigned to above-market contract-related intangible assets. One procedure that analysts typically apply to value such a contract-related intangible asset is to present value the above-market income metric (e.g., cash flow or other income-related metric) over the contract's remaining contract life.

As a best practice procedure, analysts may also consider that an at-market customer (e.g., capacity purchase agreement) or supplier contract may also have a fair value measurement value. One procedure that analysts may consider to value such an at-market contract-related intangible asset is to:

- present value the contract-related at-market expected future cash flow over the contract's remaining contract life at the target company's weighted average cost of capital ("WACC");
- present value the contract-related at-market expected future cash flow over the contract's remaining contract life at a lower present value discount rate (i.e., the lower discount rate corresponds to the reduced risk to the target company because it is a party to a long-term customer or supplier contract); and
- compare the two present value conclusions; the difference between the two present value calculations would indicate the fair value measurement of the at-market contract-related intangible asset.

This intangible asset valuation procedure recognizes that a long-term at-market supplier contract or customer contract may have an intangible asset fair value—due to the fact that the long-term contract reduces the operational risk of the target company's business.

Best Practice Number 3: Value the Acquired Liabilities—Not Just the Acquired Assets

In a business combination, ASC topic 805 calls for the fair value measurement of both the acquired liabilities and the acquired assets.

The fair value of the transferred liabilities in the business combination—particularly the long-term debt—may not be the same as the recorded accounting book value of the transferred liabilities. Any analyst

assumption that the long-term debt accounting book value equals the long-term debt fair value should be clearly disclosed—and adequately supported—in the allocation of purchase price valuation report.

In addition to the fair value measurement of the recorded liabilities transferred in the business combination, the allocation of purchase price should consider the fair value measurement of any of the following liabilities that may be transferred (or created) in the transaction:

- Contingent liabilities
- Purchase price earnout provisions
- Asset retirement obligations
- Other (non-long-term debt) liabilities

As a best practice, the fair value measurement of any transferred liability is an important component of any allocation of purchase price developed for ASC topic 805 compliance purposes.

Best Practice Number 4: Apply the CEEM or the MEEM at Least Once

As a best practice in an ASC topic 805 allocation of purchase price, analysts typically value at least one intangible asset through the application of either:

1. the multiperiod excess earnings method ("MEEM") or
2. the capitalized excess earnings method ("CEEM").

The MEEM or the CEEM is often applied in the fair value measurement of a customer-related intangible asset. However, the MEEM or the CEEM may be applied in the fair value measurement of any income-producing intangible asset acquired in the business combination.

This MEEM or CEEM application procedure—through its use of a contributory asset charge (or "CAC") based on the concluded fair values of all other acquired assets—will ensure that the total fair value of all of the acquired assets is not overstated.

This MEEM or CEEM application procedure will help to identify—and will help to quantify—the need to apply an economic obsolescence adjustment to any of the acquired assets valued by the application of the cost approach.

In the allocation of purchase price, the CEEM may also be applied as a reasonableness test of the amount of goodwill that is measured by the application of a residual calculation. That is, the CEEM goodwill valuation should be approximately equal to the goodwill calculation developed by the residual "method" required by ASC topic 805.

The application of the MEEM or the CEEM provides a reasonableness check of the fair values concluded for all of the assets acquired in the business combination. The total fair value of all of the acquired tangible assets and intangible assets can be understated or overstated if all of the acquired asset accounts are only valued by application of cost approach valuation methods, market approach valuation methods, and (non-CEEM and non-MEEM) income approach valuation methods.

The other generally accepted intangible asset income approach valuation methods do not provide this reasonableness test function that the CEEM or the MEEM do.

Best Practice Number 5: Economic Obsolescence Measurement

As a best practice in an allocation of purchase price, economic obsolescence should be consistently analyzed and (if it exists in the business combination) consistently applied in all acquired assets valued by the application of the cost approach.

This best practice of a consistent economic obsolescence analysis should be applied to all assets valued by application of the cost approach, including all tangible assets and all intangible assets.

Each analyst should clearly understand which analyst on the allocation of purchase price engagement team is responsible for measuring the economic obsolescence. That is, is economic obsolescence to be measured by the intangible asset valuation specialist or the tangible asset valuation specialist or someone else?

As a best practice, the decision as to which analyst should be responsible for measuring the economic obsolescence amount (if any) should be clearly communicated throughout the allocation of purchase price engagement team.

Without that clear understanding, each valuation analyst on the engagement team may assume another analyst will measure economic obsolescence. Or, each analyst will measure any economic obsolescence independently—and inconsistently—from the other analysts on the engagement team.

Without an understanding of who will be responsible for developing a consistent economic obsolescence analysis for all of the acquired assets in the allocation of purchase price, any acquired assets valued by the application of the cost approach may be valued inconsistently and/or overvalued.

Best Practice Number 6: Useful Economic Life Assumption

As a best practice in the allocation of purchase price fair value measurement, the analyst should document and disclose all useful economic life ("UEL") assumptions

related to all acquired tangible assets and intangible assets. That UEL disclosure and documentation should include the basis for (i.e., the support for) all of the asset category UEL estimates.

Particularly with regard to any acquired income-producing intangible asset, the analyst should understand that an asset's average UEL is typically not the same as that asset's total UEL divided by 2. This mathematical relationship affects the fair value measurement of all acquired tangible and intangible assets.

However, the impact may be greater with regard to the acquired intangible assets. This is because the income produced by the acquired intangible asset (e.g., a customer-related intangible asset) may vary from year to year.

Therefore, this UEL consideration particularly affects the fair value measurement of all acquired intangible assets valued by application of the income approach.

For example, let's compare the fair value of a customer relationship intangible asset assuming the expected future income is projected over the asset's average UEL—rather than down the expected future income decay curve associated with the asset's total UEL. Let's assume that the analyst is concluding the fair value measurement of the acquired customer relationship intangible asset.

Let's assume the target company management informs the analyst that management expects a 20 percent annual customer turnover rate—or a five-year average UEL for the acquired group of customer relationships.

Now, let's assume that the analyst decides to apply the income approach and some type of discounted cash flow ("DCF") method analysis to value this customer-related intangible asset.

Applying the income approach and the DCF method, the analyst can either:

- present value the customer-related expected future cash flow over the next five-year period (i.e., the intangible asset's average UEL) or
- present value the customer-related expected future cash flow decreasing at a 20 percent annual attribution rate (i.e., over the intangible asset's total UEL period).

However, the concluded intangible asset fair value measurement could vary materially based on which of these two UEL assumptions that analyst applies in the DCF valuation analysis.

Let's assume the current (i.e., acquisition date) group of customer relationships generate a total of $100 in cash flow per year. In applying the income approach valuation analysis, the two alternative cash flow projections that the analyst may consider are presented in Exhibit 1.

At any selected present value discount rate for the intangible asset income approach valuation analysis, the present values (i.e., the fair value measurements) of the above two customer-related intangible asset cash flow projections will be materially different.

Best Practice Number 7: Ensure WACC = WARA = IRR

As a best practice in any ASC topic 805 allocation of purchase price, the analyst should test to measure that these three rates are calculated and that they are approximately equal to each other:

- The weighted average cost of capital ("WACC") applied in the valuation of the acquired assets
- The weighted average return on assets ("WARA") implied by the fair value conclusions for all of the acquired net assets
- The deal internal rate of return ("IRR") implied by the business combination transaction total purchase price—compared to the target company's entity-level cash flow projection

This important best practice procedure provides a reasonableness test on the WACC that is applied in all of the income approach valuation analyses developed for all of the income-producing acquired assets (both tangible assets and intangible assets).

Exhibit 1
Customer Relationships Intangible Asset
Illustrative Fair Value Measurement
Impact of Applying Alternative UEL Assumptions

Projection Year	5-Year Average UEL Annual Cash Flow ($)	20% Annual Decay Rate UEL Annual Cash Flow ($)
1	100	100
2	100	80
3	100	64
4	100	51
5	100	41
6		33
7		26
8		21
9		17
10		13
11		11
12		9

This important best practice procedure provides a reasonableness test of the analyst's total fair value measurement conclusions for all of the acquired assets (both tangible assets and intangible assets).

And, this important best practice procedure ensures that the analyst understands (and that the allocation of purchase price reflects) the actual business combination acquisition transaction, including the acquirer's expected cash flow from the target company and the acquirer's expected return on investment on the target company acquisition purchase price.

Best Practice Number 8: Develop a Goodwill Valuation

As a best practice in an ASC topic 805 allocation of purchase price, the analyst should quantify the goodwill associated with the target company acquisition. In applying this best practice, the analyst may apply a CEEM (or other) analysis to value the target company's goodwill.

Of course, ASC topic 805 requires that goodwill be "measured" (not "valued") as a residual amount in the business combination allocation of purchase price. Therefore, this residual calculation will determine the amount of goodwill that is actually recorded on the post-acquisition balance sheet.

Nonetheless, the analyst may compare:

1. the quantified value of the goodwill (based on, say, the CEEM analysis) to
2. the residual amount of goodwill measured in the allocation of purchase price.

These two goodwill amounts (i.e., CEEM value indication and the residual calculation) should be reasonably close to each other.

This best practice procedure provides a reasonableness test of the calculated residual amount of goodwill in the allocation of purchase price. This best practice procedure indicates if the analyst either undervalued or overvalued the fair value measurements of the various acquired net asset categories.

In addition, this best practice procedure tests whether the residual goodwill calculation amount is sufficient to encompass an implied fair value for the acquired trained and assembled workforce intangible asset.

Best Practice Number 9: Develop an Assembled Workforce Valuation

It is a best practice to develop at least a preliminary fair value measurement for the acquired assembled workforce intangible asset in each ASC topic 805 allocation of purchase price.

Analysts and accountants understand that the trained and assembled workforce intangible asset value is not separately reported in an ASC topic 805 allocation of purchase price. However, the allocation of purchase price residual goodwill measurement should be sufficient to include the indicated fair value measurement for the acquired assembled workforce intangible asset.

As a best practice, this indicated assembled workforce fair value measurement allows a due diligence check on the reasonableness of the residual goodwill measurement. And, a trained and assembled workforce is an Internal Revenue Code Section 197 intangible asset within the context of a federal income tax allocation of purchase price.

Accordingly, if the business combination is a taxable transaction for federal income tax purposes, then the analyst may have to conclude the fair market value of the assembled workforce—in order to provide a tax basis for Section 197 amortization purposes.

Best Practice Number 10: Consider the Tax Amortization Benefit Adjustment in Certain Intangible Asset Valuations

The tax amortization benefit ("TAB") adjustment recognizes that some acquired intangible assets qualify as Section 197 amortizable intangible assets for federal income tax purposes. There is a value increment associated with the market participant being able to claim an amortization income tax deduction for the intangible asset purchase price.

That tax deduction is calculated over the Section 197 15-year amortization period. That TAB value increment typically increases the fair value measurement of the acquired intangible asset.

Some income-producing intangible assets are valued as the present value of the net cash flow (or some other income metric) generated by the acquired intangible asset over its expected UEL.

In the valuations of these income-producing intangible assets, the expected future cash flow and the present value discount rate are typically developed on an after-tax basis. Typically, a marginal income tax rate is applied in this income approach valuation analysis.

If the intangible asset value is amortizable for federal income tax purposes, then there is an additional (amortization) expense that should be recognized in the future income projection. The decreased taxable income (related to the amortization expense) results in decreased income tax expense—but increased future net cash flow (after the addback of the noncash amortization expense).

As an alternative explanation for why a TAB adjustment is appropriate, the analyst should understand that

the use of the marginal tax rate overstates the income tax expense related with the income generated by the amortizable intangible asset.

Based on this explanation, the TAB is the present value of the income tax expense difference between:

1. the assumed marginal tax rate and
2. the actual/effective (after amortization deduction) tax rate.

That TAB adjustment increases the intangible asset's annual cash flow over the Section 197 15-year amortization period—and thereby increases the intangible asset's income approach value.

It is a best practice to add the TAB adjustment to an intangible asset value indication:

- related to a Section 197 intangible asset,
- developed by the application of the income approach,
- developed using after-tax valuation variables,
- developed using a marginal income tax rate, and
- related to an assumed taxable asset transfer business combination structure.

It is a best practice not to add the TAB adjustment to an intangible asset value indication:

- related to an intangible asset that does not qualify as a Section 197 intangible asset,
- developed by the application of the cost approach or the market approach,
- developed using pretax valuation variables,
- developed using a reduced income tax rate, and
- related to an assumed nontaxable business combination structure.

In order to quantify the fair value of the income-producing intangible asset with the TAB adjustment, one procedure is to:

- value the intangible asset without the inclusion of the TAB adjustment in the discounted cash flow valuation analysis,
- conclude that preliminary income approach value indication for the intangible asset,
- divide the preliminary intangible asset value indication by 15 years,
- subtract these annual amortization expense deductions from the intangible asset's expected future income projection,
- re-run the intangible asset discounted cash flow valuation analysis but in this second iteration:
  - subtract the annual amortization expense from the projected pretax income,
  - apply the marginal income tax rate in the income projection,
  - add the annual (noncash) amortization expense to the projected annual cash flow, and
  - present value the adjusted annual cash flow projection.

The revised (or second iteration) intangible asset discounted cash flow analysis value conclusion incorporates the TAB adjustment value increment.

An alternative procedure to quantify the fair value of the income-producing intangible asset with the TAB adjustment is to apply the following formula:

$$Adjustment\ Factor = \frac{1}{1 - \left(\frac{income\ tax\ rate}{amortization\ period}\right) PVAF}$$

where:

The "income tax rate" is the income tax rate applied in the intangible asset discounted cash flow valuation analysis.

The "amortization period" is 15 years.

The present value annuity factor ("PVAF") is based on the discount rate applied in the intangible asset discounted cash flow valuation analysis.

To incorporate this TAB adjustment measurement into the income-producing intangible asset valuation, the analyst would simply apply the following formula:

Preliminary Value × TAB Adjustment Factor = Final Value

where:

The "preliminary value" is the income approach value indication for the income-producing intangible asset before consideration of the TAB adjustment

The "TAB adjustment factor" is calculated as presented in the above-listed formula

The "final value" is the fair value measurement of the income-producing intangible asset after the inclusion of the TAB adjustment value increment

Best Practices for Other Fair Value Measurement Issues

In addition to the "top 10" best practices for fair value measurements recommended above, there are numerous other issues that analysts should consider with regard to analyses developed for financial accounting purposes.

The following discussion presents additional best practices related to these slightly less common—but still important—fair value measurement development and reporting issues.

Best Practice Number 11: Consider Both Excess Assets and Surplus Assets

As a best practice in the ASC topic 805 allocation of purchase price, the analyst should consider whether the target company owns either excess assets or surplus assets.

First, the analyst should understand the difference between excess assets and surplus assets. Excess assets are not needed to serve or support the target company business operations.

Excess assets have the potential to be sold separately from the other assets of the target company. Therefore, excess assets should be valued separately and independently from other acquired assets.

Surplus assets are not needed to serve or support the target company business operations. But, surplus assets cannot be separated from the target company and sold separately. Therefore, surplus assets should be valued to the target company with any other assets that are in the same asset category.

Second, the analyst should value any target company excess assets and any target company surplus assets included in the business combination. The analyst should apply the appropriate generally accepted property appraisal approach and method to value either the excess assets or the surplus assets.

Third, the analyst should include the fair value measurement conclusion of any excess assets or any surplus assets in the allocation of purchase price.

Best Practice Number 12: Responsibility of the Principal Analyst

Most ASC topic 805 allocation of purchase price analyses are developed by a team of valuation specialists. This is because the fair value measurements typically involve a number of different property valuation disciplines. These property valuation disciplines may include real estate appraisal, tangible personal property appraisal, intangible personal property appraisal, and other financial asset appraisal.

In multidiscipline engagement teams, there is typically a principal analyst or team leader. This principal analyst coordinates the efforts of the multidiscipline engagement team. And, this principal analyst has the primary responsibility for concluding and reporting the allocation of purchase price fair value measurements.

As a best practice, and as a valuation professional standard, the allocation of purchase price valuation report certification should disclose what asset values the principal analyst is responsible for and what asset values any other property valuation specialists are responsible for. Without such a valuation report certification disclosure limitation, the principal analyst is responsible for all of the asset (and liability) fair value measurement conclusions.

As a best practice in an allocation of purchase price analysis, the principal analyst may obtain written confirmation from each property valuation specialist on the engagement team with regard to the following issues:

- The acknowledgement of their responsibility for the individual asset category fair value measurement conclusions
- The acknowledgement that their concluded standard of value for their property discipline (e.g., market value) is consistent with the ASC topic 805 fair value standard of value

Best Practice Number 13: Disclose Assumptions regarding Any Accounts Not Appraised

In an ASC topic 805 allocation of purchase price analysis, it is a best practice to disclose and to document all assumptions regarding any asset accounts and any liability accounts that were not subject to valuation procedures.

Depending on the scope of work agreed to in the allocation of purchase price engagement, analysts sometimes assume that fair value equals accounting book value with regard to the following categories of acquired assets and liabilities:

- Working capital accounts
- Other assets/investments
- Tax assets and liabilities
- Regulatory assets and liabilities
- Certain (nondebt) liabilities

If the analyst made such an assumption in the allocation of purchase price analysis, then this assumption should be disclosed, explained, and supported.

In the allocation of purchase price valuation report, the analyst should explain why it is credible to assume that no revaluation analysis is required for these acquired asset or liability accounts.

Best Practice Number 14: Compliance with VPO Professional Standards

As a best practice, all analysts (from all property valuation disciplines) on the allocation of purchase price engage-

ment team should be familiar with all valuation professional organization ("VPO") appraisal standards that may apply to the fair value measurement assignment.

Such VPO appraisal standards may include the following:

- *Uniform Standards of Professional Appraisal Practice*
- International Valuation Standards Council Standards
- American Institute of Certified Public Accountants *Statement on Standards for Valuation Services*
- Appraisal Institute standards
- American Society of Appraisers standards
- Other VPO standards

As a best practice, the allocation of purchase price valuation report should disclose which VPO standards the valuation development and the valuation report complied with. To ensure compliance with all relevant VPO standards, the principal analyst of the engagement team should understand all VPO standards that may apply to the allocation of purchase price assignment.

As a best practice, the principal analyst should also be aware of—and should comply with—the Certified in Entity and Intangibles Valuation ("CEIV") diligence and documentation professional standards.

These CEIV best practices are documented in the following two publications:

- *The Mandatory Performance Framework*
- *The Application of the Mandatory Performance Framework*

Best Practice Number 15: Document and Disclose All Extraordinary Assumptions

As a best practice, and as a valuation professional standards requirement, the analyst should document and disclose all assumptions related to the allocation of purchase price analysis.

In addition to any analyst-developed assumptions, the valuation report should disclose any material management-developed representations, including the following:

- Target company financial projections
- Asset conditions
- Projected asset replacements, renewals, retirements
- Estimates of tangible asset and intangible asset UELs
- Other valuation variable-related assumptions

Each analyst-developed and each management-developed assumption or representation should be disclosed and documented in the valuation report. The valuation report reader should be able to understand the basis for all material valuation variable-related assumptions in the allocation of purchase price.

As a best practice, the analyst should understand that fair value is the value of the target company to a market participant. Fair value is not necessarily the value of the target company to the actual buyer of the target company.

The actual buyer often applies buyer-specific assumptions in the transaction pricing analysis. Such buyer-specific assumptions applied in the business combination pricing considerations may include the following:

- Buyer-specific financial projections
- Buyer-specific expected synergies and other post-acquisition consolidation benefits
- Buyer-specific cost of capital considerations
- Buyer-specific income tax considerations

As part of the allocation of purchase price due diligence, the analyst should come to understand all of the buyer's specific transaction pricing considerations. In addition, the analyst should adjust (or normalize) all buyer-provided financial projections and other valuation analysis variables in order to eliminate any nonmarket

participant assumptions from the fair value measurement analyses.

Best Practice Number 17: Understand Property Appraisal Jargon and Procedures

As a best practice, the principal analyst should communicate directly with all property valuation specialists working on the allocation of purchase price engagement team. As mentioned above, the engagement team often includes valuation specialists from various property appraisal disciplines, including real estate appraisal, tangible personal property appraisal, and intangible personal property appraisal.

The principal analyst on the engagement team should ensure that all property valuation specialists on the team apply a consistent:

- standard of value and premise of value;
- highest and best use ("HABU") conclusion;
- set of transaction-based or market-participant-based valuation variables, such as present value discount rate, expected long-term growth rate, and income tax rate; and
- understanding of the target acquisition transaction and the business combination transaction purchase price.

The principal analyst should generally understand the property appraisal approaches, methods, and procedures applied in all of the property appraisal disciplines that affect the purchase price allocation. In order for the engagement team to work effectively and in order for the overall purchase price allocation to be internally consistent, the principal analyst should coordinate the various analyses developed by the valuation specialists from the various property appraisal disciplines.

In order to function as the engagement team leader and coordinator, the principal analyst should be familiar with the appraisal jargon of the various property appraisal disciplines involved in the allocation of purchase price.

As a few simple examples of such property discipline-specific appraisal jargon, the principal analyst should understand that:

- land is not the same as site,
- replacement cost new is not the same as reproduction cost new, and
- appraisal depreciation is not the same as accounting depreciation.

Best Practice Number 18: The Allocation of Purchase Price Report

As a best practice, the allocation of purchase price report will typically include the following:

- A list of all of the documents that the analyst relied on to develop the fair value measurements
- A list of all of the individuals (including members of target company management) whom the analyst interviewed

In addition, the allocation of purchase price report will typically include (often in a report appendix) all of the important source documents that the analyst relied on to develop the fair value measurements.

All of the allocation of purchase price analyses and fair value measurement conclusions presented in the report should be replicable. The allocation of purchase price report should include sufficient data and explanation in order to allow another analyst to replicate the valuation analyses and reach the report's fair value measurement conclusions.

Best Practice Number 19: Allocation of Purchase Price Report Value Conclusion

As a best practice, the allocation of purchase price report should appropriately describe the analyst's fair value measurement conclusion. The report should make the analyst's assignment—and the analyst's conclusion—clear to the report reader, including the understanding of the following:

- Analysts "estimate" fair value (in an attempt to emulate market participant actions).
- Analysts do not "determine" fair value (because analysts are not transaction negotiators).
- Market participants actually do "determine" fair values (in their business combination transaction negotiations).

Best Practice Number 20: Do Not Confuse Accuracy with Precision

As a best practice, the allocation of purchase price report should not imply a false level of precision in the fair value measurement analyses and conclusions.

Accuracy is not the same as precision. Analysts should understand that the allocation of purchase price report can be more accurate (meaning correct or credible) at a lower level of precision.

Analysts should apply a consistent level of mathematical rounding (i.e., precision):

- within each asset or liability valuation analysis,
- within each valuation method applied or each asset or liability value indication concluded,
- for each asset or liability account analyzed in the fair value measurement, and
- in any asset or liability final fair value conclusion.

Analysts should typically apply the "rule of significant digits" principle of algebra when adopting a rounding convention in the allocation of purchase price analysis and report.

Best Practice Number 21: Allocation of Purchase Price Report Disclosures

As a best practice, the allocation of purchase price report should clearly explain how all of the selected valuation variables were developed. That is, the allocation of purchase price report should distinguish between the following categories of valuation variables:

- Valuation variables based on empirical data
- Valuation variables based on the analyst's quantitative or qualitative analysis
- Valuation variables based on the analyst's assumptions
- Valuation variables based on management's representations

In order to make the alternative categories of valuation variable development clear to the report reader, the allocation of purchase price report may include language such as the following:

- The data indicate . . .
- My analysis indicates . . .
- I assume that . . .

Best Practice Number 22: Consider Both the Buyer and the Seller Expectations

As a best practice, the analyst may conduct due diligence interviews of the buyer's transaction negotiators in order to better understand the business combination transaction.

The analyst may ask questions such as the following:

- What did you think you were buying in the transaction?
- What assets and liabilities were important to you during the transaction negotiation?
- What (nonmarket) strategic factors did you consider in the transaction?

As a best practice, the analyst may conduct due diligence interviews of the seller's transaction negotiators in order to better understand the business combination transaction.

The analyst may ask questions such as the following:

- What did you think you were selling in the transaction?
- What assets and liabilities were important to you during the transaction negotiation?
- What (nonmarket) strategic factors did you consider in the transaction?

The allocation of purchase price fair value measurement conclusions should be generally consistent with the transaction participants' expectations.

Best Practice Number 23: The Assets Should Be Valued as Part of the Acquired Entity

All of the asset fair value measurement conclusions should represent market participant values. All of the

asset fair value measurement conclusions should be an "exit price."

However, the target company asset fair value measurement conclusions typically should not be stand-alone values. That is because the business combination buyer purchased all of the acquired assets as part of one target company going-concern entity. And, the business combination buyer will "exit" the acquired business by selling one target company going-concern entity.

The allocation of purchase price analysis should incorporate consistent valuation variables in each component asset fair value measurement. For example, all of the component asset analyses in the purchase price allocation should apply consistent valuation variables such as the following:

- Present value discount rates
- Direct capitalization rates
- Expected long-term growth rates
- Income tax rates
- Economic obsolescence adjustments
- Other valuation variables

All of the property valuation specialists should typically appraise all of the target company's acquired assets as part of one going-concern business entity.

Best Practice Number 24: Goodwill Is a Measurement—Not a Valuation

It is a best practice for the allocation of purchase price report to refer to the residual goodwill calculation as a measurement. Analysts "value" working capital accounts, real estate, tangible personal property, identifiable intangible assets, and liabilities. In contrast, analysts "measure" goodwill.

This jargon (i.e., "value" versus "measure") is consistent with ASC topic 805, the *Mandatory Performance Framework*, and other best practices. This jargon (i.e., "value" versus "measure") discloses an important distinction to the allocation of purchase price report reader.

Best Practice Number 25: The Transaction Price Is Not Always Fair Value

As a best practice, the analyst should determine whether or not the actual transaction purchase price is equal to the target company fair value.

The analyst should understand that the actual business combination purchase price is often greater than the target company's fair value. The actual transaction purchase price may exceed the market participant fair value for the target company for many reasons, including the following:

- The buyer may have included buyer-specific considerations in the transaction pricing analysis
- The buyer may have overpaid for the target company due to buyer emotion or to competitive bidding during the transaction negotiation process

The analyst should understand that the purchase price may also be less than the target company's fair value. For example, the seller may have wanted to close a transaction quickly or privately—and therefore accepted a price that is less than a market participant fair value price.

Accordingly, the analyst should develop a target-company-level valuation analysis. The purpose of that analysis is to determine if the business combination transaction is, in fact, a bargain purchase transaction.

The analyst should consider the fair value of the target company when analyzing the fair value of the target company acquired assets.

Analyst Caveats regarding the Fair Value Measurement Analysis

This discussion section recommends several caveats for the analyst who is leading the allocation of purchase price engagement team. These caveats primarily relate to the procedural components of a fair value measurement as a valuation service.

Analyst Caveat Number 1: Have Someone Check Your Work

As a best practice, the analyst should have a trusted colleague review all of the allocation of purchase-price-related valuation work. This review may include the following engagement components:

- All analyst valuation judgments
- All valuation variables selected (and rejected) by the analyst
- All math calculations
- All allocation of purchase price narrative report sections
- The consistency of all allocation of purchase price report exhibits to the report narrative
- The reasonableness of the final fair value measurement conclusions

The analyst may also have a trusted colleague check the allocation purchase price for compliance with all relevant VPO professional standards. Of course, the analyst should

ensure that the trusted colleague is technically competent to perform this professional standards review procedures.

Analyst Caveat Number 2: Don't Misrepresent the Engagement Work Product

If the analyst is engaged to advise the acquirer company management with regard to that management's valuation analyses, then the analyst is performing an advisory service. When performing such an advisory service, the analyst is not developing an independent valuation or appraisal. Rather, the analyst is assisting acquirer management with management's valuation or appraisal.

The acquirer company management needs to understand what the analyst is responsible for—and what the company management is responsible for. In addition, the allocation of purchase price report reader needs to understand what the analyst is responsible for—and what (the non-valuation-specialist) acquirer company management is responsible for.

Analyst Caveat Number 3: Will You Support Your Analysis?

Some analysts are not willing to support the allocation of purchase price valuation analysis during a challenge or contrarian review. For example, some accounting firms perform valuation advisory services to assist the acquirer company management with the client's purchase price allocation. These accounting firms may not be willing to support the allocation or purchase price valuations—through expert testimony—when the fair value measurements are challenged.

These allocation of purchase price fair value measurements may be challenged:

- By the Securities and Exchange Commission (for public company acquirers)
- By dissenting minority shareholders
- By financial institutions
- In claims of accounting fraud and misrepresentation
- In an Internal Revenue Service tax audit

If the analyst is not willing to support the allocation of purchase price analyses and conclusions through expert testimony, then the analyst should make that position perfectly clear to the acquirer company client at the beginning of the engagement.

Analyst Caveat Number 4: If You Don't Know What You Are Doing. . .

If the analyst is not completely competent to develop all aspects of the allocation of purchase price assignment, then the analyst should not perform the analysis. An allocation of purchase price engagement requires many specialized skills. This type of specialized engagement is not the place for "on the job" training.

An allocation of purchase price valuation is not a business valuation. It is a property appraisal. Even experienced business valuation specialists may not have the specialized property appraisal skill set needed to develop the allocation of purchase price fair value measurements.

The allocation of purchase price assignment requires a unique combination of the following skill sets: financial accounting, income tax accounting, financial analysis, and property appraisal. Obviously, the analyst performing this type of client engagement should have the appropriate professional competence.

Summary and Conclusion

This discussion presented numerous best practices for developing and reporting fair value measurements for financial accounting compliance purposes.

Many of these best practices relate to all fair value measurements developed for various ASC topic 820, *Fair Value Measurement*, financial accounting purposes. However, this discussion focused on allocation of purchase price analyses prepared in compliance with ASC topic 805, *Business Combinations*.

In particular, this discussion considered the following topics:

- When fair value measurements apply in financial accounting instances
- The differences between fair value measurements and fair market value valuations
- Top 10 best practices for avoiding common fair value measurement errors
- Other best practices for addressing other fair value measurement application issues
- Analysts caveats and best practices related to the allocation of purchase price assignment

These best practices are intended to assist analysts to develop and report financial-accounting-related fair value measurements effectively and efficiently—and in compliance with all relevant professional standards.

Robert Reilly is a managing director in our Chicago practice office. He can be reached at (773) 399-4318 or at rfreilly@willamette.com.

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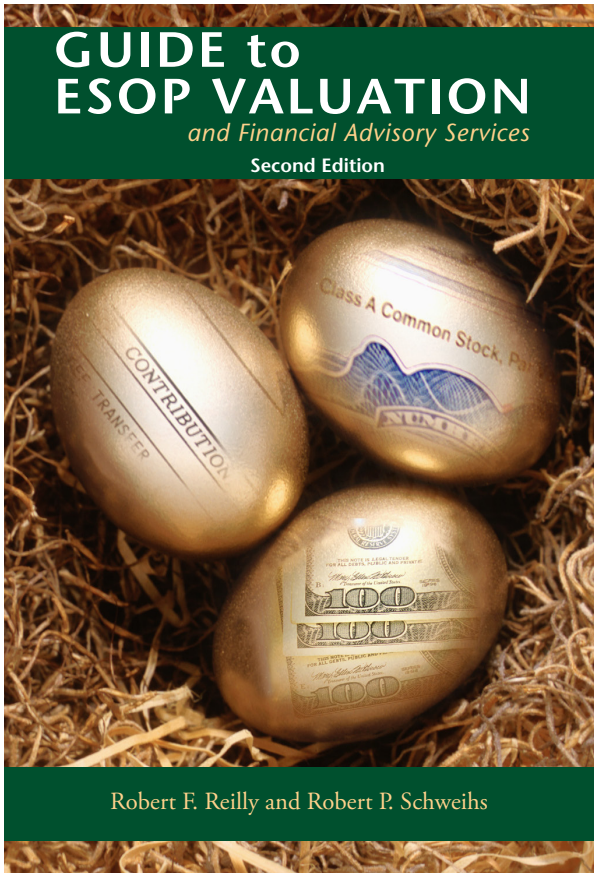

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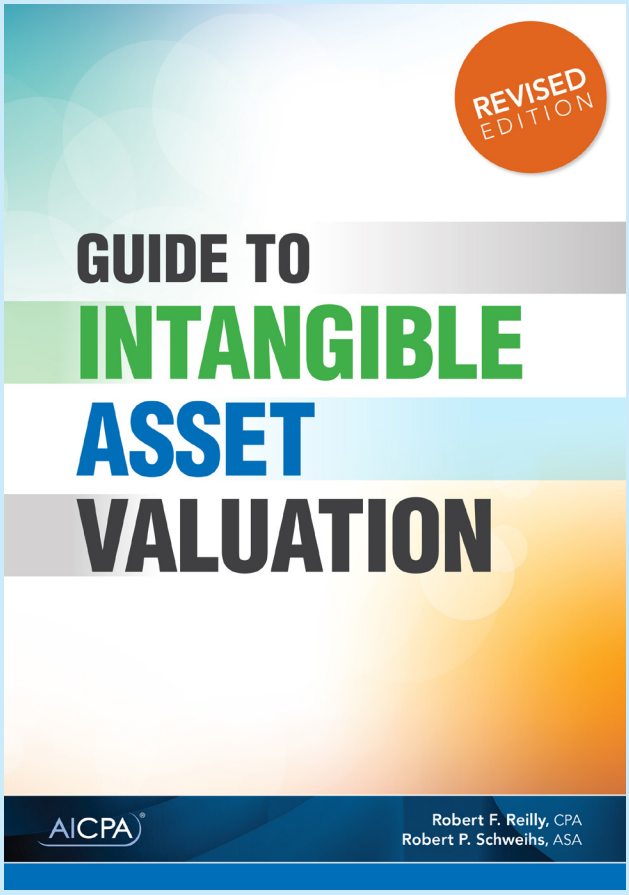

This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

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Guide to Intangible Asset Valuation

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Best Practices Discussion

Best Practices for Analyzing Economic Variables in Periods of Economic Uncertainty and Volatility

Charles A. Wilhoite, CPA

Valuation, damages, and transfer price analyses—whether developed for transaction, litigation, taxation, financial accounting, regulatory compliance, or business planning purposes—should encompass (1) a reasonableness assessment of the relevant facts and circumstances, (2) compliance with relevant professional standards and application of generally accepted approaches and methods, and (3) due diligence related to the selected economic analysis variables. These selected economic analysis variables are sometimes referred to as analysis assumptions or analysis inputs. Insufficient due diligence of and inadequate support for the selected economic analysis variables can cause a transaction counterparty, another analyst, the Internal Revenue Service, a judicial finder of fact, a government regulator, or any other party to doubt the analyst's conclusions. Supporting the selected economic variables with appropriate due diligence procedures is an important procedure in any valuation, damages, or transfer price analysis. Such due diligence may be particularly challenging during periods of significant economic uncertainty and volatility.

Introduction

Valuation, damages, and transfer price analyses—including analyses developed for transaction, taxation, regulatory compliance, financial accounting, and other purposes—are usually rendered as of a specific point in time. That specific point in time represents the date on which the valuation, damages, or transfer price analysis opinion is effective (i.e., the "as-of date").

In most valuation, damages, or transfer price analyses, the analyst has to develop and document due diligence procedures related to numerous economic factors. Such economic factors may affect both the analysis procedures performed and the analysis conclusion reached.

The following list of illustrative economic factors is not exhaustive. This list introduces some of the economic factors that the analyst may consider in the due diligence phase of the valuation, damages, or transfer price analysis:

1. The historical and prospective operating performance or financial performance of the subject entity (i.e., the business interest or the property subject to analysis)
2. The historical and prospective performance of the relevant economy (e.g., international, national, regional, local)
3. The historical and prospective performance of the subject company's—or the subject property's—industry (with consideration of the industry overall and, possibly, of specific competitive companies or properties)

For purposes of the above list (and for purposes of this discussion), the term company includes both (1) the entire business enterprise and (2) the component debt and equity securities of the subject business enterprise.

Also, for purposes of this discussion, the term property includes both (1) real estate and tangible personal property and (2) intangible personal property.

Typically, the average industry operating cycle that may be relevant for developing the above-referenced due diligence ranges from 5 years to 10 years. Typically, the duration of the operating cycle considered in the due diligence includes both an uptrend and a downtrend in a cyclical industry.

Consideration of an entire industry operating cycle allows an analyst to:

1. establish a baseline regarding the company's or property's operating results given the economic and industry conditions existing when these results were achieved and
2. develop reasonable projection variables regarding prospective operational and financial performance metrics regarding the subject company or subject property.

In many industries, the industry operating cycle often encompasses unexpected events and circumstances. Based on their nature, the recurrence of such industry events and circumstances may be difficult for the analyst to predict.

For example, in the five-year period between 2018 and 2022, many business operating cycles were affected by:

1. the COVID-19 pandemic ("COVID"), which resulted in significant economic disequilibrium and related supply-chain and industry disruptions, and
2. the escalation of the Russo-Ukrainian War in February 2022 (the "Russo-Ukrainian Escalation"), which resulted in significant economic disruptions in trade and in food and fuel prices (which contributed to high inflation rates and increased interest rates).

A valuation, damages, or transfer price analysis with an effective date (or measurement date) subsequent to the declaration of the COVID pandemic in March 2020 or the Russo-Ukrainian Escalation in 2022 may include consideration of the impact of each event on the historical and expected performance of the subject company or subject property.

The following list includes several economic analysis variables that may be incorporated in the due diligence related to valuation, damages, or transfer price analyses:

1. Subject company or subject property operating performance metrics
2. Subject company or subject property financial performance metrics
3. Normalization adjustments to historical operational or financial performance metrics
4. Present value discount rates and direct capitalization rates
5. Market-derived valuation pricing multiples or other price indications
6. The weighting (or reconciliation) of various analysis method indications or conclusions
7. Analysis synthesis and conclusion adjustments

The following discussion summarizes the due diligence and other procedures that an analyst can consider to ensure that the selected economic variables are supported and credible, particularly when considering the impact of unpredictable events such as COVID and the Russo-Ukrainian Escalation.

The following discussion does not describe generally accepted valuation analysis, damages measurement, or transfer price determination methods. Such descriptions are beyond the scope of this discussion. And, such descriptions are readily available in the relevant professional literature.

This discussion focuses on best practices related to the analyst's due diligence procedures in the assessment and the selection of the economic variables considered in a valuation, damages, or transfer price analysis.

A Period of Economic Uncertainty and Volatility

Because of the previously identified economic and industry impacts attributable to COVID and the Russo-Ukrainian Escalation, analysts may consider calendar years 2017 through 2022 (the "Operating Period") to be a period of economic uncertainty and volatility.

Exhibit 1 presents a summary of certain economic indicators and selected industry indices for the Operating Period.

The following observations summarize the comparison of (1) economic indicators and industry indices reported for the pre-COVID period of 2019 and (2) the corresponding measures reported as of September 30, 2022 ("the current period"):

- Inflation increased materially, from an annual rate of 2.3 percent in 2019 to an annual rate of 8.2 percent in the current period
- Unemployment was fairly consistent, at 3.6 percent in 2019 and 3.5 percent in the current period
- The gross domestic product ("GDP") growth rate decreased from an annual rate of 2.29 percent in 2019 to 1.77 percent in the current period
- The federal funds rate increased materially, from 1.75 percent in 2019 to 3.25 percent in the current period

Exhibit 1
Selected Economic Indicators and Industry Indices
For the Period of January 1, 2017, through September 30, 2022

	12/31/2017	12/31/2018	12/31/2019	*3/31/2020*	12/31/2020	*3/31/2021*	12/31/2021	*3/31/2022*	9/30/2022
Inflation - CPI (%)	2.1	1.9	2.3	*1.5*	1.4	*2.6*	7.0	*8.5*	8.2
Unemployment Rate (%)	4.1	3.9	3.6	*4.4*	6.7	*6*	3.9	*3.6*	3.5
GDP Growth (%)	2.26	2.92	2.29	*0.82*	-3.40	*1.19*	5.67	*3.68*	1.77
Federal Funds Rate (%)	1.50	2.50	1.75	*1.25*	0.25	*0.25*	0.25	*0.50*	3.25
Prime Rate (%)	4.40	5.35	4.75	*3.73*	3.25	*3.25*	3.25	*3.38*	5.73
30-Day Treasury Bond (%)	1.28	2.44	1.48	*0.05*	0.08	*0.01*	0.06	*0.17*	2.79
1-Year U.S. Treasury Bond (%)	1.76	2.63	1.59	*0.17*	0.09	*0.07*	0.39	*1.63*	4.05
5-Year U.S. Treasury Bond (%)	2.20	2.51	1.69	*0.37*	0.36	*0.92*	1.26	*2.42*	4.06
Moody's Aaa Corp. Bond (%)	3.53	4.01	3.00	*3.07*	2.25	*3.04*	2.71	*3.47*	4.92
10-Year U.S. Treasury Bond (%)	2.40	2.69	1.92	*0.7*	0.93	*1.74*	1.52	*2.32*	3.83
20-Year U.S. Treasury Bond (%)	2.58	2.87	2.25	*1.15*	1.45	*2.31*	1.94	*2.59*	4.08
30-Year U.S. Treasury Bond (%)	2.74	3.02	2.39	*1.35*	1.65	*2.41*	1.90	*2.44*	3.79
Retail Grocery Index	575.50	464.60	585.41	*504.78*	599.21	*625.01*	672.69	*702.19*	651.77
% Change vs. 12/31/19				*-14%*	*2%*	*7%*	*15%*	*20%*	*11%*
Crude Oil-Avg. Closing Price	$50.80	$65.23	$56.99	*$29.21*	$39.68	*$62.33*	$68.17	*$108.50*	$87.55
% Change vs. 12/31/19				*-49%*	*-30%*	*9%*	*20%*	*90%*	*54%*
DJIA	24,837.51	23,062.40	28,462.14	*21,917.16*	30,409.56	*32,981.55*	36,398.08	*34,678.35*	28,725.51
% Change vs. 12/31/19				*-23%*	*7%*	*16%*	*28%*	*22%*	*1%*
S&P 500	2,673.61	2,506.85	3,230.78	*2,584.59*	3,756.07	*3,972.89*	4,766.18	*4,530.41*	3,585.62
% Change vs. 12/31/19				*-20%*	*16%*	*23%*	*48%*	*40%*	*11%*
Nasdaq	6,903.39	6,635.28	8,972.60	*7,700.10*	12,888.28	*13,246.87*	15,644.97	*14,220.52*	10,575.62
% Change vs. 12/31/19				*-14%*	*44%*	*48%*	*74%*	*58%*	*18%*

Sources: U.S. Bureau of Labor Statistics, Federal Reserve Bank, U.S. Department of the Treasury, and Bloomberg.

- The 20-year U.S. Treasury Bond interest rate increased from 2.25 percent in 2019 to 4.08 percent in the current period
- The Retail Grocery Index increased 11 percent in the current period relative to the 2019 level
- The average closing price for a barrel of crude oil increased 54 percent in the current period relative to the 2019 price level
- The Dow Jones Industrial Average ("DJIA") index increased 1 percent in the current period relative to the 2019 level
- The S&P 500 Index (the "S&P 500") increased 11 percent in the current period relative to the 2019 level
- The Nasdaq Index (the "Nasdaq") increased 18 percent in the current period relative to the 2019 level

With the exception of inflation, interest rates and oil prices, the changes in the above-listed economic indicators and industry indices suggest that economic conditions in the current period are comparable to economic conditions at year-end 2019. However, the economic outlook as of the current period is quite different from the economic outlook that existed as of year-end 2019.

The difference in the economic outlook as of each time period is largely attributable to the trend in economic indicators leading to each period end. The 2017 through 2019 time period generally reflected stable trends in inflation, unemployment, interest rates and market indices. The 2019 through current period end—including the impacts of COVID and the Russo-Ukrainian Escalation—reflects escalating inflation and interest rates and volatile oil prices, bracketed by a stable unemployment rate.

The combined impact of low and stable unemployment, increasing inflation, increasing interest rates, and volatile oil prices created investor unrest between 2019 and the current period. That investor unrest is reflected in the volatile stock market indices during that time period.

While the DJIA, S&P 500, and Nasdaq indices increased 1 percent, 11 percent, and 18 percent, respectively, between year-end 2019 and the current period, the

various index levels increased 28 percent, 48 percent, and 74 percent, respectively, between year-end 2019 and year-end 2021.

Between year-end 2021 and the current period, the DJIA, S&P 500, and Nasdaq indices experienced decreases of 21 percent, 25 percent, and 32 percent, respectively.

An analyst developing a valuation analysis, damages measurement, or transfer price determination as of the current period would consider the subject company or subject property, the subject economy, and the subject industry actual performance levels during a period of significant economic volatility.

In addition, the analyst may have to estimate the expected performance levels for the subject company or subject property while contending with an outlook of continuing economic uncertainty and volatility as of the current period.

Estimating Subject Company or Subject Property Operating Performance Variables

Depending on many factors, analysts often assess a historical 5-year or 10-year operating history as the basis for developing projections of prospective results of operations for a subject company or property. The objective of such an assessment of historical operating and financial data is to project prospective operating and financial metrics for the subject company or property.

Depending on the analytical approaches and methods applied, such prospective results of operations may be considered in the valuation, damages, or transfer price analysis.

Illustrative Analysis of and Selection of Economic Variables

Let's assume that an analyst is retained to develop a business valuation and to estimate the fair market value of a hypothetical subject business enterprise as of September 30, 2022. This discussion summarizes the analyst's due diligence process and describes the analyst's selection of the relevant economic variables.

For purposes of this illustrative business enterprise valuation, the term business enterprise is defined to include (1) all long-term interest-bearing debt and (2) all equity accounts.

Exhibit 2 presents summary operating results for Good Grocery Group ("GGG"). GGG is a hypothetical regional grocery store chain operating in the northwest United States. During the Operating Period, GGG experienced revenue, gross profit, operating income, and pretax income increases at a compound annual growth rate ("CAGR") of 11.5 percent, 12.9 percent, 45.4 percent, and 64.1 percent, respectively.

The GGG revenue growth rate increased materially, at 17.7 percent in fiscal year ("FY") 2020—the first year of COVID—and 10.9 percent in FY 2021. In FY 2020, the GGG gross profit margin reached the highest level over the period (and in the GGG history), at 30.3 percent, and the GGG operating income margin more than doubled, from 3.5 percent in FY 2019 to 7.8 percent in FY 2020. The GGG operating income continued to increase in FY 2021, increasing to 8.8 percent, before decreasing in FY 2022 to 8.4 percent.

The reported, unadjusted (i.e., not normalized) GGG operating results during the Operating Period present a picture of revenue growth and increasing profit margins. Based solely on consideration of the GGG unadjusted operating results during the Operating Period, an analyst

Exhibit 2
Good Grocery Group
Historical and Common Size Income Statements

	Fiscal Year Ended September 30					*CAGR*	Fiscal Year Ended September 30					*Average*
	2022 $000	2021 $000	2020 $000	2019 $000	2018 $000	*2018-2022* *%*	2022 %	2021 %	2020 %	2019 %	2018 %	*2018-2022* *%*
Revenue	524,023	482,228	434,864	369,393	339,134	*11.5*	100.0	100.0	100.0	100.0	100.0	*100.0*
Change from Prior Period	*8.7%*	*10.9%*	*17.7%*	*8.9%*	*9.4%*							
Gross Profit from Operations	153,724	143,725	131,951	102,416	94,652	*12.9*	29.3	29.8	30.3	27.7	27.9	*29.1*
Income from Operations	43,872	42,257	34,041	12,765	9,804	*45.4*	8.4	8.8	7.8	3.5	2.9	*6.6*
Pretax Income	40,104	38,641	30,262	8,763	5,531	*64.1*	7.7	8.0	7.0	2.4	1.6	*5.7*

Sources: Based on GGG audited financial statements and analyst calculations.

may conclude that the value of GGG increased during that time period.

However, the GGG operating results that may be included in a valuation, damages, or transfer price analysis may require consideration of "normalization" adjustments. Such normalization adjustments remove the impact of unusual and/or nonrecurring revenue or expense amounts. Such normalization adjustments may indicate financial performance that is more representative of the future financial or operational metrics for the subject company or subject property.

Exhibit 3 presents the GGG "normalized" financial fundamentals. After normalization adjustments, the GGG pretax income ranged from $7.1 million in FY 2018 to $46.3 million in FY 2022, representing a CAGR approximating 60 percent and averaging $27.1 million over the Operating Period. Normalized operating income, or earnings before interest and taxes ("EBIT"), ranged from $9.1 million in FY 2018 to $48.8 million in FY 2022, representing a CAGR of just over 52 percent and averaging $29.4 million.

Normalized operating cash flow, or earnings before interest, taxes, depreciation and amortization ("EBITDA"), ranged from $11.6 million in FY 2018 to $52 million in FY 2022, representing a CAGR approximating 46 percent and averaging (approximately) $32.2 million.

Exhibit 3 also presents the GGG historical operating fundamentals related to depreciation and amortization expense, capital expenditures, and interest-bearing debt, among other information. As presented in Exhibit 3, and over the Operating Period, annual depreciation and amortization expense and annual capital expenditures averaged approximately $2.7 million and $2.6 million, respectively.

Exhibit 3
Good Grocery Group
Normalized Financial Fundamentals

	Fiscal Year Ended September 30,					5-Year	*CAGR*
	2022	2021	2020	2019	2018	Average	*2018-2022*
	$000	$000	$000	$000	$000	$000	*%*
Reported Operating Results:							
Revenue	524,023	482,228	434,864	369,393	339,134	429,929	*11.5*
Change from Prior Period	*8.7%*	*10.9%*	*2.6%*	*8.9%*	*NA*		
Pretax Income	40,104	38,641	30,262	8,598	5,531	24,627	*64.1*
Total Normalization Adjustments:	6,190	1,585	1,612	1,612	1,561		
Normalized Pretax Income	46,294	40,226	31,874	10,210	7,093	27,139	*59.8*
(1 - Estimated Corporate Income Tax Rate)	0.79	0.79	0.79	0.79	0.79		
Normalized Net Income	36,572	31,779	25,180	8,066	5,603	21,440	*59.8*
Normalized Net Income Margin	*7.0%*	*6.6%*	*5.8%*	*2.2%*	*1.7%*		
Deprerication and Amortization Expense	3,208	3,095	2,550	2,401	2,457	2,742	*6.9*
Interest Expense	2,500	2,400	2,300	2,200	2,000		*5.7*
Normalized Income Measures:							
Earnings before Interest and Taxes	48,794	42,626	34,174	12,410	9,093	29,419	*52.2*
Change from Prior Period	*14.5%*	*24.7%*	*175.4%*	*36.5%*	*NA*		
Margin	*9.3%*	*8.8%*	*7.9%*	*3.4%*	*2.7%*	6.4%	
Earnings before Interest, Taxes, Depreciation, and Amortization	52,003	45,721	36,724	14,811	11,550	32,162	*45.7*
Change from Prior Period	*13.7%*	*24.5%*	*147.9%*	*28.2%*	*NA*		
Margin	*9.9%*	*9.5%*	*8.4%*	*4.0%*	*3.4%*	7.1%	
Capital Requirements:							
Capital Expenditures	5,920	3,488	1,809	949	586	2,550	*78.3*
Operating Working Capital Increase (Decrease)	2,924	(3,817)	(7,019)	(705)	NA		
Balance Sheet Fundamentals:							
Interest-Bearing Debt	50,000	52,174	54,762	53,659	50,000	52,119	-
Tangible Accounting Book Value of Equity	36,373	25,746	12,881	6,196	3,556	16,950	*78.8*
Tangible Accounting Book Value of Invested Capital	86,373	77,920	67,642	59,855	53,556	69,069	*12.7*

Sources: Based on GGG audited financial statements and analyst calculations.

Considering the Impact of Unusual Events

The Operating Period includes at least two unusual events—COVID and the Russo-Ukrainian Escalation. Because of these unusual events, the general economy experienced low unemployment, continuing global trade and supply-chain issues, high inflation rates, and increasing interest rates.

During the due diligence process, the analyst develops an understanding of the impact of these two significant events on the GGG operating results. Unusual and/or nonrecurring revenue items and/or expense items are considered during a typical normalization process. Unusual events that are continuing in nature as of the analysis date may require special consideration during the due diligence process.

Let's assume that the analyst's due diligence discussions with GGG management indicated that the most significant impact relating to the two unusual events was represented by an expected increase in personnel costs in FY 2023. The analyst learned that the impact of the expected increase in personnel costs was incorporated in FY 2023 projected operating results, with historically based cost escalation projected in subsequent years.

At this point in the due diligence process, the analyst has (1) completed an internal review of the GGG historical operating results, (2) normalized historical and prospective GGG operating results, and (3) developed an understanding regarding the potential impact that unusual events may have on the GGG continuing operating results.

Based on the due diligence, and after assessing the relevant economic and industry conditions, the analyst will develop the subject company or subject property operating performance variables.

Selecting and Supporting Operating Performance Variables

GGG experienced favorable growth in revenue and operating margin during the Operating Period, on both a reported and an adjusted (or normalized) basis. As a result of the due diligence procedures developed, the analyst concluded that future GGG operating results will trend downward, moving closer to pre-COVID (i.e., FY 2019) performance levels.

Exhibit 4 presents the GGG prospective income statements for FY 2023 through FY 2026 (the "Projected Operating Period"). The analyst concluded the following observations regarding the Projected Operating Period:

- Annual revenue growth trends downward, from 5.3 percent in FY 2022 to 2.8 percent by FY 2026 (compared to a CAGR of 11.5 percent over the Operating Period).
- Gross profit margin averages 28.1 percent annually (compared with an average of 29.1 percent over the Operating Period and 27.7 percent in FY 2019).
- Adjusted operating income averages 4.7 percent annually (compared with an average of 6.4 percent over the Operating Period and 3.4 percent in FY 2019)
- Adjusted pretax income averages 4.3 percent annually (compared with an average of 5.7 percent over the Operating Period and 2.8 percent in FY 2019)

Generally, a business valuation may assign greater emphasis to operating results achieved in the more recent reporting periods. However, and based primarily on consideration of the impact of unusual events (e.g., COVID), the analyst's due diligence supports applying greater emphasis to the GGG operating performance variables that are less favorable than the operating results achieved in the recent reporting periods.

Exhibit 5 presents the analyst's illustrative discounted cash flow ("DCF") valuation analysis related to GGG. The analyst's considerations regarding the DCF valuation analysis include the following:

1. GGG projected, adjusted operating income is based on moderate revenue and earnings growth rates relative to the growth rates experienced in the most recent operating periods.
2. GGG projected, adjusted operating income represent operating margins that are more comparable to the FY 2019 (i.e., pre-COVID) performance levels than to the operating margins recognized in the most recent operating periods (i.e., post-COVID).
3. Capital expenditures are significant in the early years of the projection period and are projected to offset depreciation and amortization expense in the normalized FY 2027 period.
4. Net working capital requirements are projected at 2.5 percent of annual revenue growth.
5. Net cash flow is projected to be realized evenly throughout each year of the projection period (resulting in the application of the midyear discounting convention).
6. A 14 percent weighted average cost of capital ("WACC") discount rate is applied to convert the projected cash flow to a present value.
7. The 14 percent WACC is converted to a direct capitalization rate of 12 percent based on a 2 percent expected long-term growth rate in net cash flow.

Exhibit 4
Good Grocery Group
Business Enterprise Valuation
Income Approach
Discounted Cash Flow Valuation Method
Prospective Income Statements

	Actual FYE 9/22 $000 [a]	Projected Fiscal Year Ended September 30 2023 $000	2024 $000	2025 $000	2026 $000	CAGR 2023-2026 %	Actual FYE 9/22 %	Projected Fiscal Year Ended September 30 2023 %	2024 %	2025 %	2026 %	*4-Year Average* %
								As a Percentage of Revenue				
Revenue	524,023	551,705	567,356	583,477	600,081	2.8	100.0	100.0	100.0	100.0	100.0	
Change from Prior Year	*8.7%*	*5.3%*	*2.8%*	*2.8%*	*2.8%*							
Cost of Revenue	379,485	406,781	417,480	429,554	441,991	2.8	72.4	73.7	73.6	73.6	73.7	*73.6*
Gross Margin	144,538	144,924	149,876	153,923	158,090	2.9	27.6	26.3	26.4	26.4	26.3	*26.4*
Other Operating Income	9,186	9,606	9,887	10,184	10,489	3.0	1.8	1.7	1.7	1.7	1.7	*1.7*
Gross Profit from Operations	153,724	154,529	159,764	164,107	168,580	2.9	29.3	28.0	28.2	28.1	28.1	*28.1*
Total Operating Expenses	109,851	128,745	133,978	138,018	142,445	3.4	21.0	23.3	23.6	23.7	23.7	*23.6*
Income from Operations	43,872	25,784	25,786	26,089	26,135	0.5	8.4	4.7	4.5	4.5	4.4	*4.5*
Pretax Income	40,104	21,911	21,613	21,915	21,962	0.1	7.7	4.0	3.8	3.8	3.7	*3.8*
Change from Prior Year	*3.8%*	*-45.4%*	*-1.4%*	*1.4%*	*0.2%*							
Adjustments to Pretax Income:												
Total Adjustments	6,190	2,361	2,749	3,136	3,522	14.3	1.2	0.4	0.5	0.5	0.6	*0.5*
Adjusted Pretax Income	46,294	24,272	24,361	25,051	25,484	1.6	8.8	4.4	4.3	4.3	4.2	*4.3*
Plus Interest Expense	2,500	2,500	2,500	2,500	2,500	-	0.5	0.5	0.4	0.4	0.4	*0.4*
Equals: Adjusted Operating Income (EBIT)	48,794	26,772	26,861	27,551	27,984	1.5	9.3	4.9	4.7	4.7	4.7	*4.7*
Change from Prior Year	*14.5%*	*-45.1%*	*0.3%*	*2.6%*	*1.6%*							
Other Financial Data:												
Capital Expenditures	5,920	6,000	6,000	2,000	2,000	(30.7)	1.1	1.1	1.1	0.3	0.3	*0.7*

Notes:
Based on management-prepared financial projections and analyst due diligence discussions.
Operating expenses increased in fiscal year 2023 as a result of normalized, higher personnel costs attributable to COVID-impacted recruitment and retention.
Total adjustments relate to projected employee stock ownership plan expenses and normalized lease expenses.

As presented in Exhibit 5, the indicated total GGG business enterprise value—or market value of the invested capital ("MVIC")—based on the DCF valuation analysis, is $182 million.

In addition to projected revenue and earnings growth rates, operating margins, and capital requirements, the estimated present value discount rate and expected long-term growth rate are economic variables incorporated in the DCF valuation analysis. These economic variables, and certain considerations affecting the economic variables in circumstances of economic uncertainty, are discussed below.

Estimating the Present Value Discount Rate, Expected Long-Term Growth Rate, and Direct Capitalization Rate

A discount rate is a risk-adjusted required rate of return used to convert cash flow expected to be received in the future to a present value. A direct capitalization rate may be calculated as (1) the discount rate minus (2) the expected long-term growth rate in the measurement of income subject to capitalization.

The GGG DCF valuation analysis previously discussed incorporated a 14 percent WACC as the discount rate. A WACC is based on the weighted cost (i.e., required rate of return) of the debt and equity capital comprising a company's capital structure. The WACC represents the weighted cost of financing the operations of a company, with the weights represented by the relative percentage of debt and equity capital in the subject company's capital structure.

Exhibit 6 presents the calculation of the GGG WACC. As presented, the cost of equity capital is estimated at 15.3 percent, and the cost of debt capital is estimated at 3.9 percent. Based on a debt-to-equity capital structure including 90 percent equity and 10 percent debt, the WACC is estimated at 14 percent (on an after-tax basis).

Inflation rates and interest rates increased significantly over the Operating Period. As presented in Exhibit

Exhibit 5
Good Grocery Group
Business Enterprise Valuation
Income Approach
Discounted Cash Flow Valuation Method
Value Summary
As of September 30, 2022

	Projected Fiscal Years Ended September 30				Normalized Fiscal
	2023	2024	2025	2026	2027
Present Value of Discrete Projection Period Net Cash Flow:	$000	$000	$000	$000	$000
Adjusted Operating Income	26,772	26,861	27,551	27,984	28,544
Multiplied by: (1 - Estimated Income Tax Rate)	0.79	0.79	0.79	0.79	0.79
Net Operating Income	21,150	21,220	21,765	22,107	22,550
Net Operating Income	21,150	21,220	21,765	22,107	22,550
Normalized Depreciation and Amortization Expense	3,975	4,100	4,225	4,350	3,175
Capital Expenditures	(6,000)	(6,000)	(2,000)	(2,000)	(3,175)
Additions to Net Working Capital	(692)	(391)	(403)	(415)	(300)
Net Cash Flow to Invested Capital	18,433	18,929	23,587	24,042	22,249
Discounting Periods	0.50	1.50	2.50	3.50	
Present Value Factor @ 14 Percent	0.9366	0.8216	0.7207	0.6322	
Present Value of Discrete Projection Period Net Cash Flow	17,264	15,551	16,998	15,199	
Present Value of Discrete Projection Period Net Cash Flow	65,012				
Present Value of Terminal Projection Period Net Cash Flow:					
Fiscal 2027 Net Cash Flow	22,249				
Direct Capitalization Rate	12.0%				
Terminal Value	185,412				
Present Value Factor @ 14 Percent	0.6322				
Present Value of Terminal Period Net Cash Flow Value	117,212				
Value Summary:					
Discrete Projection Period Net Cash Flow Value	65,012				
Terminal Projection Period Net Cash Flow Value	117,212				
Indicated Market Value of Invested Capital on a Controlling, Marketable Ownership Interest Basis (rounded)	182,000				

Notes:
Based on management-prepared financial projections and analyst due diligence discussions.
Normalized fiscal 2027 adjusted operating income represents fiscal year 2026 adjusted operating income increased by the 2 percent expected long-term growth rate.
Depreciation expense and capital expenditures are estimated to offset over the long-term operating horizon.
Additions to working capital are estimated at 2.5 percent of annual revenue growth based on consideration of GGG historical working capital turnover and industry-based working capital turnover rates.
Discounting is based on a 14 percent weighted average cost of capital discount rate and the midyear convention.
The direct capitalization rate is based on the 14 percent weighted average cost of capital, reduced by the 2 percent expected long-term growth rate in net cash flow.

1, the 20-Year U.S. Treasury Bond rate almost doubled between calendar year-end 2019 and September 30, 2022, increasing from 2.25 percent to 4.08 percent. As presented in Exhibit 6, the 20-Year U.S. Treasury Bond rate is the proxy for the risk-free rate of return. Increases in the risk-free rate of return typically result in an increase in the overall WACC. This conclusion is based on the fact that a higher risk-free rate at any point in time typically increases the cost of equity capital and reflects an upward trend regarding the cost of debt capital.

Estimating the WACC often involves the analyst developing a functional analysis. The analyst's WACC-related due diligence procedures may include the following:

- Consider baseline costs of equity capital as of the analysis date, as represented by risk-free securities (i.e., the 20-Year US Treasury Bond rate), and incremental risks associated with an investment in GGG relative to an investment in a risk-free security
- Analyze the risk of GGG relative to the broad investment market, as well as the retail grocery industry and relevant participants classified in the industry
- Analyze the historical operating results, focusing on growth and variability in growth and returns

Exhibit 6
Good Grocery Group
Weighted Average Cost of Capital
As of September 30, 2022

Cost of Equity Capital:			
Modified Capital Asset Pricing Model			**Source**
Risk-Free Rate of Return		4.1%	20-year U.S. Treasury bond, *The Federal Reserve Statistical Release* as of September 30, 2022
General Equity Risk Premium (Historical)	7.46%		Kroll Cost of Capital Navigator (December 31, 2021)
Multiplied by: Industry Beta	0.50		Based on analysis of the guideline publicly traded companies
Industry-Adjusted General Equity Risk Premium		3.7%	
Small Stock and Company-Specific Risk Premium		7.5%	Kroll Cost of Capital Navigator (December 31, 2021) and analyst functional analysis considering GGG size, recent store
Indicated Cost of Equity Capital		15.3%	expansion, historical and projected financial results, operating focus, relative returns, geographic operating concentration, and dependence on long-term, key management
Cost of Debt Capital:			
Before-Tax Cost of Debt Capital		4.9%	Based on consideration of the GGG current and expected borrowing rates
Income Tax Rate		21.0%	Equals the effective corporate income tax rate
Indicated Cost of Debt Capital		3.9%	
Weighted Average Cost of Capital Calculation:			
Indicated Cost of Equity Capital	15.3%		
Multiplied by: Equity/Invested Capital	90.0%		Based on analysis of the guideline publicly traded companies, and the industry average capital structure
Equals: Weighted Cost of Equity Capital		13.8%	
Indicated Cost of Debt Capital	3.9%		
Multiplied by: Debt/Invested Capital	10.0%		Based on analysis of the guideline publicly traded companies, and the industry average capital structure
Equals: Weighted Cost of Debt Capital		0.4%	
Weighted Average Cost of Capital (rounded)		14%	
Less: Expected Long-Term Growth Rate (rounded)		2%	Analyst estimate considering GGG historical and projected gorwth, projected industry and economic growth, and long-term inflation
Direct Capitalization Rate (rounded)		**12%**	

- Analyze risks specific to GGG, including risks relating to size, geographic operating concentration, historical performance relative to projected operating results, access to capital, and any key employee dependence
- Analyze historical and prospective effective borrowing rates and the historical weighted average cost of debt

The analyst may consider the relevant variables, or inputs, required to estimate a WACC on or near the analysis date. The expected long-term growth rate also typically is estimated based on data that is known or knowable as of the relevant date.

Unusual events—such as COVID and the Russo-Ukrainian Escalation—and their related impacts may disrupt segments of the economy and the industry so significantly that the analyst may have to consider alternative procedures when estimating a discount rate. Such an alternative procedure may be considered in order to reduce the impact of significant, but temporary, volatility from the analysis.

Let's recall the economic indicators presented in Exhibit 1. As presented in Exhibit 1, real GDP growth at calendar year-end 2021, March 31, 2022, and September 30, 2022, was approximately 5.7 percent, 3.7 percent, and 1.8 percent, respectively. Similar volatility is reflected in the 20-year US Treasury rate, which was reported at approximately 1.9 percent, 2.6 percent, and 4.1 percent for the same periods, respectively. The reported inflation rate over the three periods ranged from 7 percent to 8.5 percent.

The observed GDP growth rate ranged from approximately 1.8 percent to 5.7 percent. Similarly, the analyst may incorporate a risk-free rate ranging from 1.9 percent to 4.1 percent when calculating the cost of equity capital.

As presented in Exhibit 1, over the three-year period through calendar year-end 2019 (i.e., pre-COVID), the inflation rate, the GDP growth rate, and the 20-year U.S. Treasury rate averaged, 2.1 percent, 2.5 percent, and 2.6 percent, respectively. Best practices would indicate that the analyst will develop economic analysis variables only if they are supported by facts and circumstances.

Let's assume the analyst developing the GGG business valuation concluded that it is supportable to incorporate a "normalized" risk-free rate and expected long-term growth rate, rather than the prevailing spot rates, to calculate the discount rate and the direct capitalization rate.

If the analyst reverted to historical, pre-COVID economic indicators, a risk-free rate of 2.6 percent could be selected, with the expected long-term growth rate remaining at 2.0 percent. Incorporating a risk-free rate of 2.6 percent into the discount rate analysis presented in Exhibit 6 would reduce the indicated cost of equity capital from 15.3 percent to 13.8 percent.

As a result, the discount rate would decrease from 14 percent to 13 percent, and the direct capitalization rate would decrease from 12 percent to 11 percent.

The net impact of this illustrative change would be an increase in the GGG value, based on the DCF valuation method, from $182 million to $198 million, or approximately 9 percent. The facts and circumstances regarding the GGG business valuation would indicate whether such a procedure was supportable.

Estimating and Selecting Market-Based Valuation Pricing Multiples

The market approach to valuation—whether applied through the stock and debt valuation method (sometimes called the guideline public company method) or the guideline transactions method (sometimes called the sales comparison method)—is based on the principle that market-based transactions provide informational guidance to investors.

This guidance is in the form of market-based pricing indicators that reflect relationships between (1) the prices that investors are willing to pay to acquire companies or company ownership interests and (2) the operational metrics or financial metrics of the subject companies.

Illustrative Guideline Transactions Method Valuation Analysis

Exhibit 7 presents a summarized guideline transactions method valuation analysis related to the hypothetical GGG. As presented in Exhibit 7, the analyst identified seven guideline transactions that closed between 2016 and 2021. These guideline transactions involved the transfer of companies classified in the various segments of the retail grocery industry. According to the analyst's due diligence considerations, these guideline companies were sufficiently comparable to GGG—from an investment risk and expected return perspective—to provide meaningful pricing guidance to the analyst.

The analyst's due diligence considerations regarding the guideline transactions method valuation analysis include the following:

1. The revenue level of the guideline transaction group ranged from $450 million to $15.9 billion, with a median revenue level of $4.1 billion. GGG reported annual revenue of $524 million in fiscal year 2022, exceeding the revenue level of one company in the guideline transaction group.
2. EBIT profit margins for the guideline transaction group ranged from 1.0 percent to 6.6 percent, with a median of 3.1 percent. The GGG normalized EBIT profit margin (based on the five-year average over the Operating Cycle) was 5.6 percent.
3. EBITDA profit margins for the guideline transaction group ranged from 2.4 percent to 10.3 percent, with a median of 5.9 percent. The GGG normalized EBITDA profit margin (based on the five-year average over the Operating Cycle) was 6.1 percent.
4. MVIC/revenue pricing multiples indicated by the guideline transaction analysis ranged from 0.15x to 0.92x, with a median multiple of 0.44x.
5. MVIC/EBIT pricing multiples indicated by the guideline transaction analysis ranged from 11.3x to 36x, with a median multiple of 18.5x.
6. MVIC/EBITDA pricing multiples indicated by the guideline transaction analysis ranged from 3.7x to 13.2x, with a median multiple of 9.4x.
7. Based on the analyst's assessment of GGG historical and prospective revenue, revenue growth, earnings, earnings growth, and operating margin, GGG normalized EBIT and EBITDA were estimated based on five-year average measures recognized over the Operating Period.
8. Only two of the identified guideline transactions occurred post-COVID, and insufficient data were available to enable the calculation of an MVIC/EBIT pricing multiple for either transaction.
9. Based on the analyst's due diligence consideration of all available information, particularly relative size and relative operating margins for GGG and the guideline transaction group, the analyst selected GGG MVIC/revenue and MVIC/EBITDA pricing multiples between the low-end and median multiples observed for the guideline transaction group.
10. The value indications from applying the selected pricing multiples to the GGG operating fundamentals indicated a value range of approximately $193 million (MVIC/ EBITDA) to $210 million (MVIC/revenue).

Exhibit 7
Good Grocery Group
Market Approach
Guideline Transactions Method
Value Summary
As of September 30, 2022

Selected Sales Comparison Transactional Data:

Target Company Name	Buyer Company Name	Primary SIC Code	Sale Date	Target Company Location	LTM Revenue ($000)	LTM EBIT ($000)	LTM EBITDA ($000)	Return on Revenue EBIT	Return on Revenue EBITDA	MVIC	Pricing Multiples MVIC/ Revenue	Pricing Multiples MVIC/ EBIT	Pricing Multiples MVIC/ EBITDA
Smart & Final Stores, Inc.	Bodega Latina Corporation	5411	7/28/2021	United States	4,100,000	NA	167,000	NA	4.1%	620,000	0.15	NA	3.7
Smart Foodservice Stores LLC	US Foods, Inc.	5409	4/24/2020	United States	1,100,000	NA	85,000	NA	7.7%	970,000	0.88	NA	11.4
Smart & Final Stores, Inc.	Apollo Management IX LP	5411	6/17/2019	United States	4,770,337	57,766	157,414	1.2%	3.3%	2,077,520	0.44	36.0	13.2
Martin's Super Markets, Inc.	SpartanNash Company	5410	12/31/2018	United States	450,000	NA	NA	NA	NA	84,300	0.19	NA	NA
SUPERVALU INC.	United Natural Foods, Inc.	5411	10/22/2018	United States	15,458,000	157,000	367,000	1.0%	2.4%	2,879,860	0.19	18.3	7.8
Whole Foods Market, Inc.	Amazon.com, Inc.	5411	8/28/2017	United States	15,878,000	785,000	1,324,000	4.9%	8.3%	14,617,750	0.92	18.6	11.0
The Fresh Market, Inc.	Apollo Global Management, LL(	5411	4/21/2016	United States	1,857,033	121,926	190,770	6.6%	10.3%	1,373,860	0.74	11.3	7.2
				Low	450,000	57,766	85,000	1.0%	2.4%	84,300	0.15	11.3	3.7
				Median	4,100,000	139,463	178,885	3.1%	5.9%	1,373,860	0.44	18.5	9.4
				High	15,878,000	785,000	1,324,000	6.6%	10.3%	14,617,750	0.92	36.0	13.2

Value Summary:

	LTM Revenue ($000)	LTM EBIT ($000)	LTM EBITDA ($000)	Return on Revenue EBIT	Return on Revenue EBITDA
GGG Normalized Financial Fundamentals	524,023	29,419	32,162	5.6%	6.1%
Selected Pricing Multiples	0.40	NA	6.0		
Indicated Value	209,609		192,969		
Value Measure Weight	40%		60%		
Weighted Value	83,844		115,782		
Indicated Value of Invested Capital on a Controlling, Marketable Ownership Interest Basis (rounded)	200,000				

Notes:
Based on consideration of the impacts of COVID, due diligence discussions with GGG management, and projected GGG operating results, GGG normalized EBITDA is represented by the five-year average, adjusted EBITDA.
The analyst selected pricing multiples between the observed low end and median pricing multiples.
Selected pricing multiples are based on transaction timing considerations relative to the valuation date, relative size, relative growth rates, relative profit margins, and relative returns on investment metrics. The analyst did not consider EBIT because no EBIT-based pricing multiples were observed subsequent to COVID.
Based on GGG adjusted financial operating results and guideline transactions valuation analysis; S&P Capital IQ; DealStats; FactSet Mergerstat, LLC; and PitchBook.

11. Based on the analyst's due diligence consideration of all available information, including the GGG operating focus, the GGG operating outlook, and the basis for the GGG fundamental, the analyst applied a weight of 60 percent and 40 percent to the value indications resulting from the MVIC/EBITDA multiple and the MVIC/revenue multiple, respectively.

As presented in Exhibit 7, the indicated MVIC of GGG, based on the guideline transactions method analysis, is $200 million.

The analyst's due diligence considerations affecting the selection of market-based pricing multiples in the guideline transactions analysis considered the impacts of COVID. Generally, COVID exerted a positive impact on participants in the retail grocery sector during the Operating Period, based on an observable shift in consumer behavior. As a result of both required and elective social distancing practices, food consumption at home increased as restaurant dining decreased.

Though supply-chain issues created inventory challenges for many industry participants, the shift in consumer behavior driving higher demand, in conjunction with inflationary pricing, generally offset increasing labor and operating costs.

Generally, the retail grocery sector fared well through the pandemic. However, continuing inflation, increasing interest rates, and high fuel costs created downward pressure on operating results as of the valuation date.

In a typical valuation circumstance, best practices indicate that market-based pricing multiples should be applied in a consistent manner to operating fundamentals for the subject company. In other words, a market-based pricing multiple developed using a current acquisition price and current earnings for the acquired company should be applied to current earnings for the subject company (e.g., GGG).

However, in order to account for the impact of economic disequilibrium on the subject company (or subject property) value, the analyst may consider applying a market-based pricing multiple to a "normalized" operational or financial metric level.

Regarding GGG, the analyst concluded that average, adjusted EBITDA over the five-year Operating Period represents a more supportable income level to incorporate in the valuation analysis. Specifically, applying a five-year average EBITDA level gives equal weight to operating results occurring before and after the COVID outbreak.

The result is a normalized EBITDA level that is lower than the EBITDA level GGG actually achieved in the most recent periods. The normalized EBITDA level reflects the operational and financial performance level

expected by GGG management in FY 2023 and beyond, when personnel costs are expected to increase.

As presented in Exhibit 7, the normalized EBITDA level of $32.2 million represents an EBITDA profit margin of 6.1 percent relative to FY 2022 sales of $524 million. Based on the GGG projected operating results presented in Exhibit 4, and the related depreciation and amortization expense presented in Exhibit 5, the adjusted EBITDA projected for FY 2023 is approximately $30.7 million. The FY 2023 projected EBITDA represents a profit margin of 5.6 percent relative to FY 2023 projected revenue of $551.7 million.

Illustrative Stock and Debt Method Valuation Analysis

Exhibits 8 and 9 present a summarized stock and debt method valuation for the hypothetical GGG. As presented in Exhibit 9, the analyst selected three guideline public companies that were classified in the retail grocery industry as of the valuation date.

The analyst's due diligence considerations related to the stock and debt method valuation analysis include the following:

1. As presented in Exhibit 9, the revenue level of the guideline public company group ranges from $2.1 billion to $5.4 billion, with a median revenue level of $4.3 billion. GGG reported annual revenue of $524 million in fiscal year 2022, well below the revenue level for each guideline company.
2. As presented in Exhibit 9, EBIT profit margins for the guideline public company group range from 2.1 percent to 7.0 percent, with a median of 3.6 percent. The GGG normalized EBIT profit margin for fiscal year 2022 was 9.3 percent.
3. As presented in Exhibit 9, EBITDA profit margins for the guideline public company group range from 3.8 percent to 9.2 percent, with a median of 6.0 percent. The GGG normalized EBITDA profit margin for fiscal year 2022 was 9.9 percent.

Exhibit 8
Good Grocery Group
Market Approach
Stock and Debt Method Valuation Analysis
Value Summary
As of September 30, 2022

Value Measure	Good Grocery Group $000	Guideline Publicly Traded Company Pricing Multiples Low	High	Median	Selected Pricing Multiple	Market Value of Invested Capital $000	Value Measure Weight	Weighted Value $000
MVIC/EBIT:								
Latest 12 Months	48,794	6.9	17.8	16.0	6.0	292,764	0.05	14,638
5-Year Average	29,419	10.1	22.5	20.0	9.0	264,774	0.25	66,194
MVIC/EBITDA:								
Latest 12 Months	52,003	5.3	9.8	9.6	5.0	260,013	0.05	13,001
5-Year Average	32,162	7.0	12.1	11.1	7.0	225,131	0.25	56,283
MVIC/Revenue:								
Latest 12 Months	524,023	0.37	0.57	0.49	0.35	183,408	0.40	73,363
							1.00	
Indicated Value of Invested Capital on a Controlling, Marketable Ownership Interest Basis (rounded)								223,000

Notes:
The analyst calculated guideline company pricing multiples by applying a 10 percent ownership control price premium to the share price of the guideline companies, based on current market conditions, and consideration of GGG revenue and earnings levels and historical trends.
The analyst selected EBIT and EBITDA pricing multiples at or slightly below the indicated range based on consideration of GGG smaller size, recent store expansion and expected growth, limited geographic diversification, the state of the relevant local economies, and relative performance factors between GGG and the guideline companies.
The analyst calculated the selected revenue pricing multiple based on consideration of the previously identified factors, with emphasis on consideration of the GGG and the guideline company relative revenue growth and profitability.
Based on GGG adjusted financial operating results and guideline company analysis, including the analyst's due dilingence review of SEC Forms 10-K and 10-Q for the guideline companies.

Exhibit 9
Good Grocery Group
Market Approach
Selected Guideline Public Companies
Comparison of Operating Performance

Size (LTM revenue, $000)	
Ingles Markets, Incorporated	5,381,570
Weis Markets, Inc.	4,322,146
Village Super Market, Inc.	2,069,864
Good Grocery Group	**524,023**

Size (LTM total assets, $000)	
Ingles Markets, Incorporated	21,241,747
Weis Markets, Inc.	1,896,938
Village Super Market, Inc.	913,778
Good Grocery Group	**126,945**

Growth Rate (EBITDA 5-year CAGR)	
Good Grocery Group	**43.5%**
Ingles Markets, Incorporated	17.4%
Weis Markets, Inc.	11.4%
Village Super Market, Inc.	2.9%

LTM Profitability (EBIT to revenue)	
Good Grocery Group	**9.3%**
Ingles Markets, Incorporated	7.0%
Weis Markets, Inc.	3.6%
Village Super Market, Inc.	2.1%

LTM Profitability (EBITDA to revenue)	
Good Grocery Group	**9.9%**
Ingles Markets, Incorporated	9.2%
Weis Markets, Inc.	6.0%
Village Super Market, Inc.	3.8%

Growth Rate (Revenue 5-year CAGR)	
Good Grocery Group	**11.0%**
Ingles Markets, Incorporated	6.8%
Village Super Market, Inc.	5.5%
Weis Markets, Inc.	5.3%

Liquidity (current ratio)	
Ingles Markets, Incorporated	1.9
Weis Markets, Inc.	1.9
Good Grocery Group	1.9
Village Super Market, Inc.	1.3

Activity (working capital turnover)	
Village Super Market, Inc.	51.7
Ingles Markets, Incorporated	24.0
Good Grocery Group	22.2
Weis Markets, Inc.	13.9

Leverage (equity to total capital)	
Weis Markets, Inc.	85.8%
Ingles Markets, Incorporated	60.9%
Village Super Market, Inc.	46.1%
Good Grocery Group	**38.6%**

Sources: Based on GGG adjusted financial operating results and stock and debt method analysis, including the analyst's due diligence review of SEC Forms 10-K and 10-Q for the guideline companies.

4. As presented in Exhibit 9, the five-year CAGR in revenue for the guideline public company group ranged from 5.3 percent to 6.8 percent. GGG experienced a five-year CAGR in revenue of 11 percent.
5. As presented in Exhibit 9, the five-year CAGR in EBITDA for the guideline public company group ranged from 2.9 percent to 17.4 percent. GGG experienced a five-year CAGR in EBITDA of 43.5 percent.
6. As presented in Exhibit 8, MVIC/EBIT pricing multiples resulting from the guideline public company analysis ranged from 6.9x to 17.8x, with a median multiple of 16x for the latest 12 months ("LTM"), and 10.1x to 22.5x, with a median multiple of 20x, for the five-year average.
7. As presented in Exhibit 8, MVIC/EBITDA pricing multiples resulting from the guideline public company analysis ranged from 5.3x to 9.8x, with a median multiple of 9.6x for the LTM, and 7x to 12.1x, with a median multiple of 11.1x, for the five-year average.
8. As presented in Exhibit 8, MVIC/revenue pricing multiples resulting from the guideline public company analysis ranged from 0.37x to 0.57x, with a median multiple of 0.49x for the LTM.
9. As presented in Exhibit 8 and based on the analyst's due diligence consideration of all available information, particularly relative size and relative operating margins for GGG and the guideline public company group, the analyst selected MVIC/EBIT, MVIC/EBITDA, and MVIC/revenue pricing multiples for GGG at or slightly below the low-end pricing multiples observed for the guideline public company group.
10. As presented in Exhibit 8, the value indications resulting from applying the analyst's selected pricing multiples to the GGG relevant operating fundamentals indicated an MVIC range of approximately $183 million (MVIC/LTM revenue) to $293 million (MVIC/LTM EBIT).
11. Based on the analyst's due diligence consideration of all available information, including the GGG operating focus, the GGG operating outlook, and the basis for the GGG operating fundamentals, the analyst applied a weight of 60 percent and 40 percent, respectively, to the indications of value based on earnings (i.e., EBIT and EBITDA) and on revenue.
12. As presented in Exhibit 8, within the MVIC/EBIT and MVIC/EBITDA value indications, the analyst applied weights of 5 percent and 25 percent to LTM and five-year average fundamentals, respectively, based on the analyst's consideration of expected financial results in FY 2023.

As presented in Exhibit 8, the GGG indicated MVIC, based on the stock and debt method valuation analysis, is $223 million.

The analyst's considerations affecting the selection of market-based pricing multiples in the stock and debt method valuation analysis considered the impacts of COVID. COVID had an impact on the guideline public companies analyzed related to favorable demand and pricing impacts as well as supply-chain constraints and inflationary pressures.

However, one difference between the stock and debt method analysis and the guideline transactions method analysis is that market-based pricing information developed in the guideline public company analysis is current as of the valuation date. Such pricing reflects investors' valuation date perspectives regarding the expected impact of COVID, continuing supply-chain issues, inflation, interest rates, fuel, and personnel costs.

Additionally, the stock and debt method analysis reflects the impact of informed investors operating and making decisions with the benefit of all available public information. Based on this fact, the analyst considered both LTM and five-year average operating fundamentals for GGG.

As presented in Exhibit 8, the analyst applied the lowest weight—a total of 10 percent—to the value indications based on the GGG LTM earnings fundamentals (i.e., EBIT and EBITDA).

The analyst applied a total of 50 percent weight to the GGG value indications based on the GGG five-year average earnings fundamentals. The analyst applied a weight of 40 percent to the value indication based on the GGG LTM revenue fundamental.

The analyst's weighting emphasizes GGG management expectations that, even though revenue growth is expected, FY 2023 earnings are expected to decrease relative to FY 2022 earnings as operating costs—specifically, personnel costs—are expected to increase in response to the pandemic.

Valuation Synthesis and Conclusion Due Diligence Considerations

Exhibit 10 presents the analyst's GGG business enterprise valuation summary. As presented in Exhibit 10 and based on the income approach discounted cash flow method and the market approach guideline transactions method and stock and debt method, the indicated value of the GGG business enterprise ranges from $182 million to $223 million.

Exhibit 10
Good Grocery Group
Business Enterprise (Total Invested Capital) Value
Valuation Synthesis and Conclusion
As of September 30, 2022

Valuation Approach and Valuation Method	Indicated Value $000	Relative Emphasis	Weighted Value $000
Income Approach—Discounted Cash Flow Method	182,000	65%	118,300
Market Approach—Guideline Transactions Method	200,000	20%	40,000
Market Approach—Stock and Debt Method	223,000	15%	33,450
		100%	
Market Value of Invested Capital on a Controlling, Marketable Ownership Interest Basis (rounded)			192,000

Notes:
Based on the analysis and the indicated values presented in the identified valuation approach and method summary exhibits.
The analyst applied relative emphasis to each valuation method based on the GGG size relative to the companies considered in each market approach method, and projected operating results that reflect a trend toward pre-COVID operating growth and margins. The market approach methods are based on GGG historical, normalized revenue and earnings.

As indicated in Exhibit 10, the analyst applied a weight to each value indication in order to estimate the GGG market value of invested capital.

Based on the analyst's due diligence consideration of the quantity and quality of the data supporting each valuation method, and the fact that the discounted cash flow method directly includes adjustments to expected earnings based on the estimated impact of COVID, the analyst applied 65 percent of the total weight to the value indication based on that method.

Based on the analyst's due diligence consideration of size differences between GGG and the typical company in the two market approach guideline company groups, the analyst applied more weight—20 percent—to the value indication based on the guideline transaction method than to the value indication based on the stock and debt method—15 percent.

Based on the analyst's weighting applied, the business enterprise value for the hypothetical GGG, on a controlling, marketable ownership basis, is estimated at approximately $192 million as of the valuation date.

Summary and Conclusion

There are generally accepted approaches and methods with regard to valuation analyses, damages measurements, and transfer price determinations. A description of these generally accepted approaches and methods is beyond the scope of this discussion.

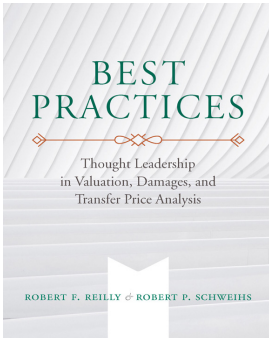
Unusual events and circumstances, such as COVID and the Russo-Ukrainian Escalation, may create significant and continuing disruption on economic and industry conditions. It is a best practice for analysts to develop sufficient due diligence in order to incorporate the impact of the economic and industry disequilibrium in the valuation, damages, or transfer price analyses.

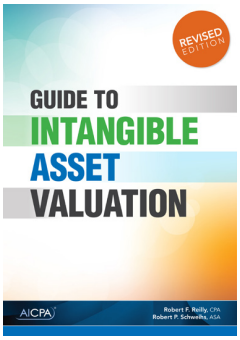
This discussion identified economic analysis variables that may affect all three types of economic analyses. Such economic variables include inputs regarding (1) revenue and earnings growth rates and operating margins; (2) present value discount rate and direct capitalization rate calculations; and (3) the development, selection, and application of market-based valuation pricing multiples.

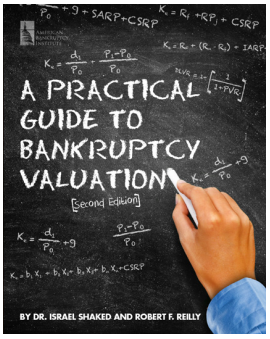
Analysts should develop and document their due diligence procedures related to unusual events such as COVID and the Russo-Ukrainian Escalation. Such due diligence procedures allow analysts to account for economic uncertainty and volatility in the valuation, damages, or transfer price analyses and conclusions.

Charles Wilhoite is a managing director at Willamette Management Associates and national director of the tax-exempt entity and health care services practice. Charles has been with the firm for over 32 years and has provided business valuation, intangible asset valuation, economic damages analysis and related testifying expert services regarding businesses and business interests across a wide range of industry classifications. Charles can be reached at (503) 243-7500, or at cawilhoite@willamette.com.

Valuation, Damages, and Transfer Price Textbooks Authored by Willamette Management Associates Authors







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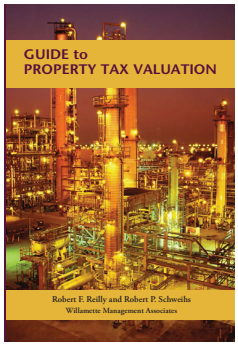

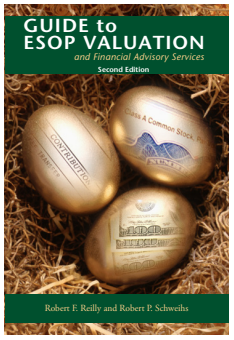

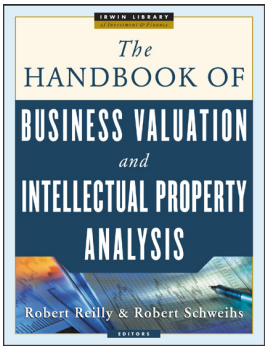

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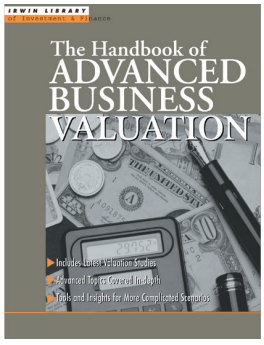

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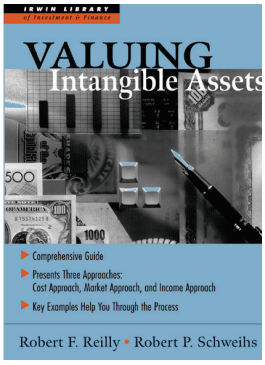

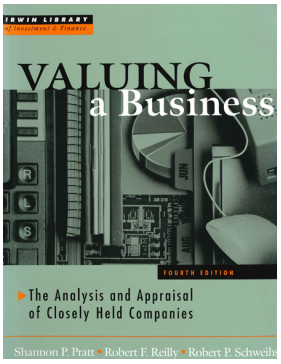

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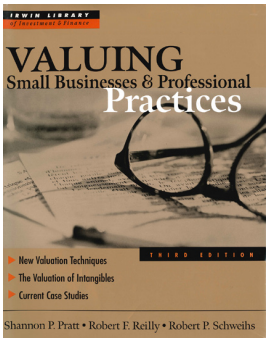

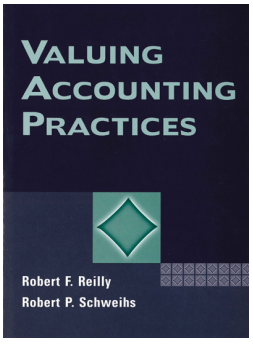

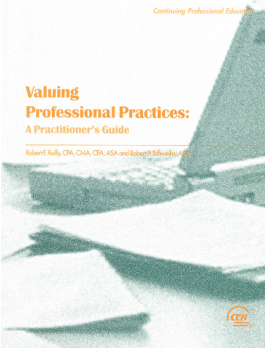

* Authored by Robert Reilly and Israel Shaked, Ph.D.
** Authored with Shannon Pratt
*** Edited by Robert Reilly and Robert Schweihs

Willamette Management Associates
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Best Practices for Reasonableness of Executive Compensation Analysis

Robert F. Reilly, CPA

The U.S. Tax Court decision in *Clary Hood, Inc. v. Commissioner* provides important practical guidance to private companies and to private company owners—and to their legal, accounting, and compensation advisers—regarding the reasonableness of executive/shareholder compensation income tax deductions. In this decision, the Tax Court provides a fulsome discussion of its application of the so-called multifactor approach to reasonableness of executive compensation analysis. This judicial decision also provides important practical guidance to forensic accountants, financial analysts, valuation analysts, and other professionals who provide testifying expert services in reasonableness of executive compensation (and in other) federal taxation disputes.

Introduction

There are many reasons why valuation analysts, damages analysts, compensation consultants, and other professional advisers may be asked to analyze—and opine on—the reasonableness of the amount of compensation paid to the employees of a private company or institution.

Assessing the reasonableness of executive/shareholder compensation is a generally accepted due diligence procedure in the development of a private company business valuation prepared for many purposes. Valuation analysts typically "normalize" the private company's historical results of operations for amounts paid to employee/owners that are in excess of what would be considered reasonable compensation for the actual services provided to the company by the employee/owner.

Assessing the reasonableness of executive compensation (including nonshareholder executives) is important for (1) a private company owned by an employee stock ownership plan ("ESOP") or (2) a not-for-profit organization. Excessive executive compensation payments may be considered unfair to the ESOP participants and may decrease the fair market value of the ESOP-owned sponsor company.

Not-for-profit organizations (whether in the health care, education, research, or other industries) may not pay more than a fair market level of compensation to executives or professionals.

Assessing the reasonableness of executive/shareholder compensation is an important due diligence procedure when a noncontrolling shareholder is claiming to have suffered damages as the result of the actions of the company's board of directors or the company's controlling shareholder. Such a damages claim may relate to either (1) shareholder oppression and breach of fiduciary duty litigation or (2) dissenting shareholder appraisal rights litigation.

And, assessing the reasonableness of executive/shareholder compensation may be particularly important in income tax disputes between the closely held company and the Internal Revenue Service. In fact, private company owners and their legal and other tax advisers often look to income-tax-related judicial decisions for guidance related to reasonableness of compensation issues. The U.S. Tax Court recently provided such judicial guidance in the matter of *Clary Hood, Inc. v. Commissioner*.

Clary Hood, Inc. v. Commissioner of Internal Revenue

The U.S. Tax Court matter *Clary Hood, Inc. v. Commissioner of Internal Revenue* involved a dispute between the Internal

Revenue Service ("the Service") and a private C corporation taxpayer Clary Hood, Inc. ("CHI") regarding the reasonableness of executive compensation paid to chief executive officer/shareholder Clary R. Hood ("Hood"). The Tax Court published its decision in T.C. Memo 2022-15 ("the *Hood* decision").

The *Hood* decision is generally favorable to the Service, concluding that the taxpayer CHI owed back income taxes for both tax years in dispute and owed an Internal Revenue Code Section 6662 substantial understatement penalty for one of the tax years in dispute.

Important to private company owners and to their professional advisers, the *Hood* decision provides a thorough analysis of "the multifactor approach" to assessing the reasonableness of executive compensation. In addition, the *Hood* decision provides a frank discussion of what the Tax Court found persuasive—and unpersuasive—about the quantitative analyses, the expert reports, and the trial testimony of the various testifying experts in this case.

Summary of the Hood Decision

Upon audit, the Service determined deficiencies in, and Section 6662 accuracy-related penalties with respect to, the CHI federal income tax returns for the tax (fiscal) years ending May 31, 2015 and 2016 (collectively, the "tax years at issue"). Exhibit 1 summarizes the conclusion of the Service's audit of CHI for fiscal years 2015 and 2016.

Although it is only a memorandum decision, the *Hood* decision presents a detailed description of the decision-making process followed by Tax Court Judge Greaves. The *Hood* decision provides a thorough discussion of the factors that the Tax Court considered in assessing the reasonableness of executive/shareholder compensation for this closely held C corporation. The decision explains the legal rationale for the court's reliance on the so-called multifactor approach. And, the decision explains the court's analysis of each factor within that multifactor approach.

Exhibit 1
Clary Hood, Inc.
Internal Revenue Service Audit
Summary of Results

Fiscal Year	Income Tax Deficiency Concluded	Section 6662 Substantial Understatement Penalty
2015	$1,581,202	$316,240
2016	$1,613,308	$322,662

Therefore, the March 2, 2022, *Hood* decision provides recent and meaningful practical guidance regarding reasonableness of executive compensation tax deduction analyses. This judicial decision provides such practical guidance to private company business owners, to tax counsel, to tax accountants, to compensation consultants, and to forensic and other financial analysts who advise private companies regarding reasonableness of executive/shareholder compensation issues.

Following the trial, the issues to be decided by the Tax Court were (1) the amount that CHI could deduct under Section 162(a)(1) as reasonable compensation paid to its chief executive officer/shareholder Clary L. Hood during the tax years at issue and (2) whether CHI was liable for the substantial understatement accuracy-related penalties under Section 6662(a) and (b)(2) for the tax years at issue.

For the reasons summarized in the following discussion (and as comprehensively described in the *Hood* decision), the Tax Court held that (1) CHI was entitled to deduct no more than $3,681,269 and $1,362,831 for the 2015 and 2016 tax years, respectively, and (2) CHI was liable for the Section 6662 substantial understatement penalty for the 2016 tax year (but not for the 2015 tax year).

The Hood Decision Findings of Fact

The following sections summarize the CHI business operations, the responsibilities of Hood as a CHI employee, and the compensation amounts paid by CHI to Hood. Most of these facts were stipulated to at trial by both the taxpayer and the Service.

Clary Hood as the Company Founder and CEO

Judge Greaves made the following important observation in the *Hood* decision: "To understand Clary Hood, Inc., one must first know Mr. Hood."

Before the years at issue in this tax dispute, Hood had dedicated his entire career to the construction industry, specializing in the construction industry segments of land grading and excavation. Hood learned the industry as a boy from his father, J.E. Hood. J.E. Hood operated his own land grading business. Upon graduation from high school in 1967, Hood joined his father's company in the land grading industry segment.

In 1980, Hood founded CHI with his wife, Gail. Together they served as the CHI sole shareholders and

sole members of the company board of directors. Hood exercised ultimate decision-making control over all of the CHI operations, from the company's founding up through the tax years at issue.

CHI Business History and Operations

Generally acting as a subcontractor, CHI concentrated on land grading and excavation services for construction projects in the South Carolina region. CHI started with two employees and a collection of used earth-moving equipment valued at less than $60,000. CHI developed into a 150-person company with nearly $70 million in revenue by the end of its 2016 fiscal year.

For the period of 2000 to 2010, the CHI revenue growth was slow and the company profits were cyclical. During that period, CHI generated less than $1 million in net income after taxes in most years. Like many construction companies in the late 2000s, CHI experienced financial distress during the "Great Recession" and sustained three years of operating losses during its fiscal years ending May 31, 2009 to 2011.

During those years, CHI survived due to its reputation and due to following strategic decisions over which Hood exercised primary, if not exclusive, control: (1) conserving cash by maintaining a low debt profile and not declaring dividends; (2) temporarily reducing employee pay; (3) withholding Hood's salary, when necessary, to ensure that sufficient funds were available to cover the company payroll needs; and (4) selling $800,000 of equipment to offset losses and to supplement cash reserves.

Based on Hood's executive decision, CHI changed strategic direction in 2012. CHI shifted away from one of the company's largest and most consistent sources of revenue: site grading work for Walmart shopping centers ("Walmart projects"). Between 1999 and 2011, Walmart project revenue generally accounted for more than 20 percent of the CHI annual revenue.

While CHI initially welcomed this steady stream of revenue, the Walmart projects created constraints on the CHI resources for timely job completion. These constraints reduced the CHI ability to pursue more lucrative grading jobs. It became apparent to Hood that the grading company needed to shift away from Walmart projects. In 2011, without seeking input from any other company executives, Hood notified the Walmart developer's representative that CHI would not engage in any future Walmart projects. Ultimately, this risky management decision would prove very beneficial for CHI.

In July 2011, CHI began diversifying its customer base by transitioning from retail-related grading work to commercial and industrial grading projects. As a result of Hood's personal efforts, CHI was placed on the bid list for a sizable potential project with a zinc recycling plant in North Carolina. CHI won that project bid. Over the next several years, that project evolved into the largest and most profitable job in the company's history, bringing in over $30 million of revenue and a gross profit margin above 40 percent.

Also in 2011, one of Hood's industry contacts enabled CHI to bid on—and win—another large grading project with one of Bridgestone's plants in Aiken, South Carolina. That project accounted for nearly $9.5 million of CHI revenue over the next few years, with the company earning an overall gross profit margin of 41 percent. Around 2014, Hood's efforts secured another large grading job, a project for the Tryon Equestrian Center. By the end of the 2016 fiscal year, that project generated over $23 million in revenue and $5.4 million gross profit for the grading company.

The CHI revenue growth and financial performance improved materially after its transition away from the Walmart projects. The company's financial performance improvement is summarized in the Exhibit 2 financial data for the CHI fiscal years ending May 31, 2000 to 2016 (the "review period").

Exhibit 2
Clary Hood, Inc.
Summary of Results of Operations
Fiscal Years Ending May 31, 2000 through 2016

Fiscal Year-End	Company Revenue ($)	Company Gross Income (Loss) ($)	Net Income (Loss) before Taxes ($)	Year-End Shareholders' Equity ($)	Year-End Cash on Hand ($)
2016	68,834,166	22,090,576	14,537,867	31,262,166	15,482,871
2015	44,111,646	13,879,822	7,088,529	21,742,422	10,059,619
2014	34,074,836	10,008,003	8,271,261	17,419,060	9,434,712
2013	42,830,999	11,755,042	7,427,560	11,965,811	5,024,051
2012	23,680,476	3,738,212	2,308,710	7,112,009	1,172,793
2011	15,575,546	1,072,062	(120,530)	5,478,422	1,234,290
2010	20,605,072	130,997	(589,730)	5,550,877	1,342,332
2009	27,757,113	1,023,856	(390,922)	5,910,615	923,853
2008	38,439,625	5,116,648	2,864,533	6,186,310	1,170,632
2007	25,898,118	3,099,005	1,294,923	4,366,759	647,649
2006	14,936,476	1,615,374	125,617	3,554,653	657,222
2005	22,150,933	2,157,518	981,456	3,476,981	140,955
2004	13,243,547	1,826,002	874,588	2,858,337	293,333
2003	9,332,724	(97,393)	(773,222)	2,330,395	137,797
2002	17,590,697	250,363	(896,490)	2,822,055	120,078
2001	25,347,752	1,531,231	(123,607)	3,378,880	342,416
2000	16,366,605	2,235,929	833,116	3,454,137	324,324

It is noteworthy that the above amounts (with immaterial exceptions) are the amounts reported on the CHI federal income tax returns. That is, the net income amounts are calculated after the company's tax deduction for Hood's compensation amounts.

It is noteworthy—particularly to the Service and to the Tax Court—that CHI never declared or paid a cash dividend to its shareholders (i.e., Clary and Gail Hood) at any time during the review period.

The CHI Management Structure

Hood used various management titles with CHI during the review period. However, during this time period, Hood's executive duties at CHI were generally the same: (1) oversight of the company's equipment fleet (procurement, use, maintenance, and disposition; (2) hiring, training, and supervision of mechanics; (3) supervision and inspection of jobsites; (4) preparation, review, and approval of job fee estimates and budgets; (5) submission and negotiation of job bids; (6) setting employee salaries and bonuses; and (7) acquisition of bonding for grading projects.

According to the trial record, Hood rarely took vacations and typically worked between 60 and 70 hours per week (including weekends). Hood's leadership and work ethic contributed to the CHI revenue growth and profitability. However, the *Hood* trial record indicated that much of the company's success was also due to the hard work and dedication of the other CHI executives: Andy Painter, Tom Addley, Chris Phillips, Mrs. Gail Hood, and Wesley Hood ("Wesley"), the son of Mr. and Mrs. Hood.

Like Hood, Wesley joined his father's construction company right after graduation from high school. After several years of operating heavy equipment for the

grading company, Wesley became more involved in the CHI management. In the 2000s, Wesley became the CHI president and CEO. However, Wesley decided to leave CHI in 2011.

Painter replaced Wesley as the CHI president at the beginning of 2012. Painter typically worked hours similar to Hood, and Painter performed the following management functions: (1) preparation of estimates for, and bidding on, prospective jobs; (2) oversight of the performance of projects; (3) engagement in business development; and (4) management of CHI daily operations.

Addley served in a similar capacity to Painter. Addley worked primarily as an onsite project manager for CHI, overseeing the performance of projects. In this management function, Addley typically worked 60 hours per week and performed the following functions: (1) assessing equipment and personnel needs, (2) maintaining client relations at project sites, and (3) monitoring the need for job modifications when warranted.

Phillips, a certified public accountant, joined CHI in 2010 as controller before becoming the company's chief financial officer in 2011. Phillips' duties at the company included (1) oversight of CHI finances; (2) review, negotiation, and payment of CHI loans; (3) oversight of insurance policies; (4) communication with bonding agents, banks, lenders, attorneys, and government agencies; (5) preparation of financial statements; (6) oversight of the CHI accounting department; and (7) continual review and analysis of costs in order to improve the company's financial efficiency.

Exhibit 3
Clary Hood, Inc.
Compensation Paid to Mr. Clary Hood
Fiscal Years Ending May 31, 2000 through 2016

For Fiscal Year	Hood Salary ($)	Hood Bonus ($)	Hood Total Compensation ($)
2016	196,500	5,000,000	5,196,500
2015	168,559	5,000,000	5,168,559
2014	181,538	1,500,000	1,681,538
2013	381,707	1,000,000	1,381,707
2012	21,100	200,000	221,100
2011	83,400	35,000	118,400
2010	132,500	-0-	132,500
2009	130,000	-0-	130,000
2008	130,000	320,981	450,981
2007	130,000	221,685	351,685
2006	131,000	242,000	373,000
2005	130,000	1,000	131,000
2004	130,000	-0-	130,000
2003	127,337	-0-	127,337
2002	130,813	-0-	130,813
2001	130,000	107,000	237,000
2000	130,000	122,000	252,000

Gail Hood acted as a general adviser to CHI on equipment needs, project needs, personnel needs, and financial management. She was also responsible for personal guaranties to bonding companies during the review period. Mrs. Hood typically worked approximately 10 hours per week during the review period, but her responsibilities with the company decreased in the later end of the review period.

The Executive/Shareholder Compensation Amounts in Dispute

There was no written employment agreement in place between Hood and the company during the review period. The CHI board of directors, which was comprised solely of Clary and Gail Hood, set the amount of Hood's annual compensation, including bonuses. Although they generally solicited and accepted the advice of the CHI independent accountants, Mr. and Mrs. Hood did not use any type of formula in setting Hood's compensation amounts during the review period—except during the tax years at issue. During the review period, Hood received from CHI the amounts presented in Exhibit 3. CHI reported these amounts as employee compensation deductions on its federal income tax returns.

Based on the CHI agreement with its bonding companies, Mr. and Mrs. Hood agreed to personally guarantee any claim the bonding companies may have had against CHI during the review period for amounts beyond the company's ability to pay (surety bond guaranties). Hood also agreed to personally guarantee payment of some of the CHI business loans, credit lines, and capital leases during the review period ("debt guaranties").

In addition, CHI lent money to—and extended credit to—Hood and to some of his other business ventures

during the review period. Before the tax years at issue in the dispute, CHI never compensated Hood (or Mrs. Hood) for the debt guaranties or for the surety bond guaranties.

In fall 2014, Phillips first discussed the issue of Hood's compensation with the CHI independent accountants at the Elliott Davis, LLC ("Elliott Davis") accounting firm. Phillips believed that Hood had been undercompensated in prior years. Phillips sought professional advice on how to develop the compensation for Hood on a going-forward basis. Jeff Greenway, an audit partner at Elliott Davis, sent Phillips a summary of salary surveys. That summary included data from a PAS, Inc. ("PAS") survey and a 2010 Construction Financial Managers Association survey. Using this information, Phillips developed preliminary calculations to determine the amount that CHI had undercompensated Hood during the review period.

Phillips, Hood, Greenway, and Stacy Stokes, a tax partner at Elliott Davis, discussed Hood's compensation situation during a fiscal year-end business meeting in May 2015. They all agreed that (1) Hood was undercompensated during the review period and (2) he deserved a catch up bonus in the amount of $5 million pending a follow-up compensation analyses.

The $5 million catch-up bonus amount was supported by an Excel spreadsheet ("the compensation due spreadsheet") developed by Phillips. The compensation due spreadsheet presented a financial model with (1) the CHI income statements for each year of the review period through May 31, 2015, (2) Hood's annual compensation for each of those years according to the CHI federal income tax returns, and (3) a series of items for each year labeled "Clary Hood Calculated Compensation."

The "Clary Hood Calculated Compensation" items included the following: (1) a base salary beginning with $200,000 for the tax year ending May 31, 2000, then increasing 5 percent annually; (2) an annual bonus amount of 20 percent of profits before taxes; (3) an annual fee of $100,000 for bonding guaranties; and (4) an annual debt guaranty fee equal to approximately 1 percent of the debt and capital leases personally guaranteed by Hood.

The compensation due spreadsheet also incorporated data from the Greenway-provided salary surveys. Following the May 2015 meeting, Stokes provided Phillips with additional research on the topic of reasonable executive compensation. Stokes also modified the compensation due spreadsheet. Stokes added line items below the income statements, including a "Total Equity" figure and a "Return on Equity for the Year" calculation for each year during the review period.

Based on these inputs and calculations, the financial model concluded a proposed $5 million catch-up bonus amount for Hood.

The CHI board of directors met on May 21, 2015. The CHI board approved $5 million as a catch-up bonus payment to Hood for its 2015 tax year ("the 2015 amount") described as "backpay compensation."

In support of this catch-up bonus amount, the CHI board minutes described the following prior services rendered by Hood during the review period:

1. Navigating CHI through "the loss of a president and long-time vice president in 2011"
2. Deciding "to change direction of the [c]ompany away from 'big box' grading work to more industrial grading opportunities"
3. "Dealing [with] and reacting to the most severe recession faced by the [c]ompany in 2009-2011"
4. "Personally guaranteeing most or all of the [c]ompany debt, capital leases, and credit lines since inception"
5. Acting as the "[p]ersonal guarantor to the [c]ompany's bonding company since inception"
6. "Providing a steadying influence to both customers, vendors, and, most importantly, employees"
7. "Leading the [c]ompany by being prudent in seeking job opportunities and the purchasing of

equipment necessary to handle the [c]ompany's emergent work opportunities"

8. "Personally overseeing that equipment used by Clary Hood, Inc. on job sites met or exceeded expectations in the performance of the job"
9. "Managing and leading the [c]ompany over the most profitable four year run in its existence."

Listing exactly the same reasons, the CHI board approved another $5 million as a catch-up bonus payment to Hood on May 20, 2016 ("the 2016 amount").

It is noteworthy that Hood personally set the salaries and bonuses for all CHI officers and personnel on an individual basis. For the fiscal years ending May 31, 2010 through 2016, CHI paid its officers and other executive employees (other than Hood) the amounts presented in Exhibit 4—amounts that it characterized as compensation expense (excluding bonuses).

For the fiscal years ending May 31, 2013 through 2016, CHI also paid its officers and other executive employees (other than Hood) additional amounts—amounts that it characterized as bonuses. These annual bonus payment amounts are presented in Exhibit 5.

Notice of Deficiency and Filing of the Tax Court Petition

Following an audit of the CHI federal income tax returns, the Service issued a notice of deficiency for the tax years at issue. The notice of deficiency concluded that portions of Hood's compensation paid for the tax years at issue exceeded reasonable compensation amounts under Section 162(a)(1). The Service disallowed the deduction for these alleged excess (greater than reasonable amount) compensation payments.

The Service allowed $517,964 of the $5,711,105 total amount CHI reported as compensation for Hood for the 2015 tax year and $700,792 of the $5,874,585 total amount CHI reported as compensation for Hood for the 2016 tax year. The Service's notice concluded total deficiencies of $1,581,202 and $1,613,308 for the 2015 and 2016 the tax years, respectively.

The Service's notice also included accuracy-related penalties under Section 6662 for underpayments due to the substantial understatement of income tax of $316,240 and $322,662 for the 2015 and the 2016 tax years, respectively.

In response to the Service's notice of deficiency, CHI filed a petition with the U.S. Tax Court, disputing (1) the disallowed compensation amounts and (2) the Section 6662 substantial understatement penalties.

The Tax Court's Opinion

The Tax Court memorandum opinion provides a fulsome discussion of the court's analysis of the factors affecting the reasonableness of Hood's executive compensation (and of CHI's income tax deduction). The decision first addressed the issue of why the taxpayer CHI had the burden of proof in the *Hood* matter.

Burden of Proof

Not surprisingly, the Tax Court concluded that (1) the Service's determinations set forth in its notice of deficiency are generally presumed to be correct and (2) the taxpayer (in this case, CHI) bears the burden of proving that the determinations are in error. Specifically, the *Hood* decision mentions *Cozart Packing Co. v. Commissioner*,[1] which applies this presumption to a reasonable compensation determination. Citing *INDOPCO, Inc. v. Commissioner*,[2] the *Hood* decision states the rule that the taxpayer bears the burden of proving entitlement to any deduction claimed.

After addressing the initial burden of proof issue, the *Hood* decision systematically described the relevant issues related to a reasonableness of executive/shareholder compensation analysis.

Exhibit 4
Clary Hood, Inc.
Compensation (Other than Bonuses) Paid to Senior Executives
Fiscal Years Ending May 31, 2000 through 2016

For Fiscal Year	Andy Painter Compensation $	Tom Addley Compensation $	Gail Hood Compensation $	Chris Phillips Compensation $	Wesley Hood Compensation $
2016	233,654	233,654	104,800	114,900	52,000
2015	191,500	191,500	85,546	74,000	52,000
2014	178,646	178,646	56,480	52,083	52,000
2013	113,907	113,907	26,000	51,454	3,000
2012	-0-	-0-	24,220	50,824	20,520
2011	-0-	-0-	23,680	23,400	164,080
2010	-0-	-0-	26,500	19,600	157,000

Reasonableness of Executive/ Shareholder Compensation Tax Deductions

Tax Deduction Requirements under Section 162(a)

CHI, a C corporation, is subject to federal income tax on its taxable income, which is its gross income less allowable deductions. Under Section 162, a corporation may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Such expenses include a reasonable allowance for salaries or other compensation; for example, bonuses or for personal services actually rendered. Whether the compensation payments are reasonable and purely for services is a question of fact to be determined based on all the facts and circumstances of each particular case. In its discussion of the facts and circumstances criteria, the memorandum decision cited *Martens v. Commissioner*[3] and *American Savings Bank v. Commissioner*.[4]

Since it was an issue in the *Hood* matter, it is noteworthy that an employer may deduct compensation paid to an employee in a year although the employee may have performed the services in a prior year. To support this proposition, the *Hood* decision cited *Lucas v. Ox Fibre Brush Co.*[5] and *R.J. Nicoll Co. v. Commissioner*.[6] However, the employer has to show that (1) the employee was not sufficiently compensated in the prior year and (2) the current year's compensation was in fact paid to compensate for that underpayment. To support this proposition, the *Hood* decision cited *Estate of Wallace v. Commissioner*.[7]

The *Hood* decision specifically stated:

> Another consideration is whether the employee was also a shareholder of the corporation. Where officer-shareholders are in control of a closely held corporation and set their own compensation, careful scrutiny is required to determine whether the alleged deductible compensation is in facto a nondeductible dividend.

In this regard, the *Hood* decision cited *Richlands Medical Association v. Commissioner*[8] and *Estate of Wallace v. Commissioner*.[9]

The Multifactor Approach to Assessing the Reasonableness of Compensation

The Tax Court recognized that the U.S. Court of Appeals for the Fourth Circuit, the appeals court to which an appeal of the *Hood* matter would be made, requires consideration of multiple factors in determining reasonable compensation (the so-called multifactor approach). These multiple factors include the following:

Exhibit 5
Clary Hood, Inc.
Bonus Amounts Paid to Senior Executives
Fiscal Years Ending May 31, 2013 through 2016

For Fiscal Year $	Andy Painter Bonus $	Tom Addley Bonus $	Gail Hood Bonus $	Chris Phillips Bonus $
2016	100,000	80,000	-0-	60,000
2015	40,000	40,000	-0-	30,000
2014	30,000	30,000	-0-	25,000
2013	25,000	25,000	-0-	25,000

the employee's qualifications; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; and the salary policy of the taxpayer as to all employees. In its discussion of this multifactor approach, the *Hood* decision cited *Richlands Medical Association v. Commissioner*.[10]

In the context of a private corporation with a limited number of officers, additional reasonableness of compensation factors to consider may include (1) the amount of compensation paid to the particular employee in the previous years (as considered in *Mayson Manufacturing Company v. Commissioner*[11]) and (2) any personal guaranties of debts or other obligations of the corporation (as considered in *E.J. Harrison & Sons, Inc. v. Commissioner*[12]).

In the application of the multifactor approach, no single factor is considered to be decisive. Instead, the trial court may consider and weigh the totality of the factors and circumstances when making its decision (as in *Martens v. Commissioner*[13]). In doing so, the trial court may find certain factors less relevant or helpful than other factors when considering the factors necessary to reach a reasonableness of compensation conclusion (as in *Medina v. Commissioner*[14]).

The Independent Investor Test

Some federal courts have applied the so-called independent investor test to analyze the reasonableness of private company executive/shareholder compensation. Some of the judicial decisions that applied the independent investor test include (1) *Metro Leasing & Development Corporation v. Commissioner*[15] (noting that the independent investor test is one of several factors that may be considered in analyzing the reasonableness of executive/

shareholder compensation); (2) *Haffner's Service Stations, Inc. v. Commissioner*[16] (rejecting the independent investor test as the only test and instead applying a multifactor approach with consideration of the taxpayer company's profit and return on equity); and (3) *Exacto Spring Corp. v. Commissioner*[17] (relying primarily on the independent investors test).

Under this independent investor test of reasonable executive/shareholder compensation, the court typically considers, "whether an inactive, independent investor would be willing to compensate the employee as he was compensated" (see *Elliotts, Inc. v. Commissioner*[18]).

In the *Hood* matter, CHI asked the Tax Court to follow the independent investor test in determining whether the compensation paid to Hood in the tax years at issue was reasonable. At least one Court of Appeals has accepted the independent investor test in a reasonableness of compensation dispute. However, the *Hood* decision noted that the U.S. Court of Appeals for the Fourth Circuit has not adopted any version of the independent investor test.

In addition, the *Hood* decision noted that the Tax Court generally applies the multifactor approach unless a case is appealable to a Court of Appeals which has expressly applied the independent investor test. See, for example, (1) *Pepsi-Cola Bottling Co. of Salina v. Commissioner*[19] (noting that it is "well settled" that the Tax Court should consider the multifactor approach in reasonable compensation cases); (2) *Beiner, Inc. v. Commissioner*[20] (refusing to apply the independent investor test exclusively by finding comparative industry salaries the most relevant factor in that case; and (3) *Metro Leasing & Development Corporation v. Commissioner*[21] (concluding that it was not "appropriate to rely solely on the independent investor test to reach our findings and/or holding").

Therefore, in the *Hood* matter, the Tax Court concluded that it should apply the multifactor approach to determine the reasonableness of the CHI compensation paid to Hood (1) based on the precedent of the Tax Court and, more importantly, (2) based on the precedent of the Court of Appeals for the Fourth Circuit (see *Golsen v. Commissioner*[22]).

The Tax Court Analysis of Hood's Compensation

In the judicial decision, Judge Greaves specifically mentioned "There is no doubt that Mr. Hood is the epitome of the American success story." In the *Hood* matter, the parties did not dispute that Hood was entitled to some degree of additional compensation for the prior services he rendered as a CHI employee during portions of the review period.

It is not the responsibility of either the Tax Court or the Service to substitute its business judgment for that of the CHI board as to the setting of the appropriate amount of an employee's compensation. However, it is the responsibility of the Tax Court to examine the extent to which that compensation may be deducted form federal income tax purposes. That is because, as even CHI management recognized, limits do exist as to what may be reasonably deducted as compensation expense.

From a federal income tax perspective, the Service challenged whether the increase in Hood's compensation in the 2015 and 2016 CHI fiscal years constituted (1) deductible employee compensation or (2) a means of draining corporate profits through a disguised dividend. For the reasons concluded from each of the factors described below, the Tax Court held that CHI could not deduct the full amount of compensation paid to Hood. Based on the court's assessment, CHI failed to adequately establish how the entire amount was both reasonable and paid solely as compensation for Hood's services to CHI during the review period.

Hood's Background and Qualifications

An employee's superior qualifications for his or her position may justify high compensation. With over 50 years of relevant work experience, Hood had substantial knowledge and experience in both managing and performance grading and excavation work. In addition, Hood had developed an excellent reputation in his market. The court recognized that Hood's reputation allowed CHI to compete for, and win, subcontracting jobs.

The Nature, Extent, and Scope of Hood's Work

An employee's position, duties performed, hours worked, and general importance to the private corporation's success may justify high compensation. The court recognized that Hood was the CHI key employee and driving force since the company's inception. Hood managed and built up the CHI business, solicited and obtained grading jobs, and supervised all work performed.

In addition, Hood made the executive decisions (1) to sever business dealings with Walmart and (2) to transition to the commercial and industrial market sectors, a decision which led to the CHI financial success.

The Size and Complexity of the CHI Business Operations

Courts may consider the size and complexity of a taxpayer's business when deciding the reasonableness of compensation paid to its executive/shareholders.

During the review period, CHI experienced exceptional growth in terms of both employees and revenue. The CHI workforce increased from approximately 80 to 150 employees. And, the CHI annual revenue increased

from as low as $9 million in 2003 to over $68 million by 2016. The *Hood* decision noted, "Even if we were to assume that land excavation and grading does not require substantial scientific or technical knowledge, petitioner's work is more complex than that of a general construction company."

CHI specialized in the land grading and excavation sectors of the construction industry. This industry sector requires performance of the following services at exacting specifications: earth excavation, site clearing and grading, storm drainage, installation of water systems, installation of curbs and gutters, landscaping, and irrigation services.

As a result of Hood's contributions, CHI created a niche in that specialty segment by (1) competing in a cost-effective manner and (2) developing an excellent reputation in its market.

Comparison of Hood's Compensation to the CHI Income

Although it is often helpful for analysts to measure executive/shareholder compensation as a percentage of both gross receipts and net income, the net income analysis is typically considered to be more important. This is because the net income analysis more accurately gauges whether a private company is disguising the distribution of dividends as compensation. A taxpayer's pattern of attempting to distribute a significant portion of its pretax net income as deductible executive/shareholder compensation may indicate that the private company is disguising dividends as compensation. That said, no particular ratio between executive/shareholder compensation expense and gross or net table income is a prerequisite for a determination of reasonableness.

In the instant case, CHI paid approximately 42 percent and 26 percent of its pretax income to Hood as compensation in its 2015 and 2016 fiscal years, respectively. In the *Hood* matter, the Tax Court did not find those percentages to indicate an egregious pattern of disguised dividends.

The Prevailing Economic Conditions

The prevailing economic conditions may help to determine whether the success of a business is attributable to the efforts and business acumen of the executive/shareholder, as opposed to being attributable to general trends in the economy. Adverse economic conditions, for example, tend to indicate that an executive/shareholder's skill was important to a private company that increased in size during bad economic years.

In the instant case, the CHI annual revenue increased from approximately $16 million to over $68 million during the review period. Greenway, a CPA with extensive experience in the construction industry, offered testimony at the *Hood* trial that the CHI success, at least in the post-Walmart era, was due to factors other than general economic conditions.

At trial, Greenway testified that CHI was his most profitable construction client between 20013 and 2016. Even the Service's testifying expert offered confirmation of this view. The Service's testifying expert placed the CHI performance in the upper quartile of its industry peers for the post-Walmart era. During that time period, CHI attained its most profitable jobs through Hood's direct involvement.

At trial, Hood testified that the CHI poorest performance years were predominantly attributable to years of national economic contractions. At trial, Hood testified that many of the CHI competitors went out of business during these economic downturns. Hood, on the other hand, took active measures as CEO to ensure the CHI survival during such economic downturn periods. Those measures included (1) selling equipment; (2) reducing employee compensation, including Hood's own compensation; and (3) conserving financial resources.

Comparison of Hood's Compensation with Distributions to Stockholders

It is not a legal requirement for a private corporation to pay dividends. And, private company shareholders are often content to enjoy the appreciation in the value of their stock that arises through the retention of company earnings. However, a complete absence of dividends to shareholders may result in an inference that some of the compensation paid to an executive/shareholder represents a distribution of profits.

CHI was profitable during the review period, especially in the tax years at issue. However, CHI never declared or paid a cash dividend.

With regard to this dividend distribution factor, the *Hood* decision states, "Some of petitioner's claimed reasons for not doing so, e.g., to meet working capital needs during the Great Recession and maintain a competitive edge through strong balance sheets, are certainly persuasive when considering tax years such as 2010 in which business was slow and capital needs were high. These reasons, however, can be carried only so far before they start to lose their appeal after taking into account (1) Mr. Hood's decision, as controlling shareholder of petitioner, to defer monetary recognition through a dividend for his investment of the entire 16-year review period and (2) petitioner's decision to not recognize those deferrals through a dividend but instead reward Mr. Hood exclusively through a purported bonus after it had acquired sufficient capital and cash in the years at issue to do so."

Prevailing Compensation Rates for Comparable Positions at Comparable Concerns

In deciding whether compensation paid to an executive/shareholder is reasonable, analysts often compare it to compensation paid to persons holding comparable positions in comparable companies. Federal courts frequently place great emphasis on this comparative analysis factor.

In assessing this factor in the *Hood* matter, the Tax Court considered the testimony of the parties' testifying experts. In its decision, the Tax Court noted this principle: "As trier of fact, we are not bound by the opinion of any expert witness and will accept or reject expert testimony, in whole or in part, in the exercise of sound judgment."

The Samuel Kursh Expert Testimony

CHI offered the expert testimony of Samuel Kursh of BLDS, LLC ("BLDS"), an economic consulting firm. Kursh is an economist and BLDS principal whose experience includes corporate finance and market database analysis, as well as return on equity calculations.

The Kursh expert report ("the BLDS report") indicated that Kursh wrote the report in conjunction with his colleague Dr. Brett Margolin.

The *Hood* decision concluded that "Mr. Kursh's knowledge as to the report's content, supporting data, and calculations was materially lacking." At trial, Kursh admitted that Margolin would be better suited to answer basic questions regarding the BLDS report despite the fact that Margolin was not presented as a witness at the trial.

Regarding this expert's report, the Tax Court also concluded, "The BLDS report also lacked necessary supporting calculations and did not include all underlying data, leaving us unable to verify the veracity of its findings and conclusions."

In addition, the Tax Court commented that "The BLDS report additionally rested on numerous dubious assumptions. Perhaps most egregious, the BLDS report crudely compared the performance of petitioner, a private regional specialty construction firm, to that of dissimilar public companies such as the multinational conglomerate Caterpillar, Inc., with little attempt at adjusting for the obvious and stark differences between such companies."

Finally, with regard to the Kursh analysis, the Tax Court concluded that "the BLDS report focused on the independent investor test, which we do not find to be controlling."

The Theodore Sharp Expert Testimony

At trial, CHI also offered the expert testimony of Theodore Sharp, a senior partner at the management consulting firm Korn Ferry. Sharp is a member of the Korn Ferry Executive Pay and Governance group and specializes in compensation-relation issues, including executive compensation benchmarking. At trial, Sharp testified that he reviewed and agreed with his written expert report ("the Korn Ferry report"), but Sharp acknowledged that he had not written it.

The Korn Ferry report consisted of approximately one dozen PowerPoint slides in bullet-point format.

The Tax Court had the following observation regarding this expert's work: "As with the BLDS report, supporting calculations used to reach key findings and conclusions were conspicuously absent from the report and underlying data sources were not adequately disclosed."

The Tax Court also expressed serious concerns about the soundness of the assumptions in the Korn Ferry report. For example, the Korn Ferry report relied on compensation survey data for companies with up to $500 million in annual revenue. The expert report attempted to offset the disparity with the CHI revenue size by applying a 20 percent "discount" to the data. The Korn Ferry report explained (and Sharp confirmed at trial) that this percentage was not supported by any empirical data but was selected "based on our experience working with similarly sized companies."

The Tax Court also commented that, "The external compensation survey data relied upon in the Korn Ferry report was materially lacking in completeness as well."

Finally, with regard to this taxpayer expert witness, the Tax Court concluded, "We therefore afford Mr. Sharp's testimony little to no weight."

The David Fuller Expert Testimony

At trial, the Service offered the expert testimony of David Fuller. Fuller is the founder of Value, Inc. In his role at Value, Inc, Fuller provides financial and valuation consulting services to corporate clients in various industries, including the construction industry. His practice areas include valuation opinions for financial and tax reporting purposes, and he routinely renders advice to companies on the issue of executive compensation.

Fuller's expert report ("the Fuller report") accounted for all known amounts of compensation paid to Hood during the review period. And, the Fuller report contained detailed disclosures of the data sources relied upon, the methodologies applied, and the supporting calculations. The data that Fuller analyzed included the entire 17-year review period. Fuller compared the CHI performance against data supplied by the Risk Management Association ("RMA") survey service for site preparation contractors, using the CHI annual asset size and revenue size.

The Fuller report placed CHI in annual quartiles in a given year based on the company's performance against the RMA data. Then, the Fuller report examined

officer compensation as a percentage of revenue within the respective annual performance quartile. As part of his analysis, Fuller observed compensation data for executive/shareholders in the construction industry from the survey service PAS. And, Fuller also applied the multifactor approach.

In terms of financial metrics, Fuller concluded that CHI was a lower quartile performing business from 2000 through 2011, a median performing business in 2012, and an upper quartile performing business from 2013 through 2016. Fuller assigned lower quartile wages for a board chairman to Hood for 2000 to 2011, average wages for a board chairman to Hood for 2012, and the highest level of compensation (i.e., the 99th percentile) for a board chairman to Hood for 2013 through 2016. Fuller also concluded that elective undercompensation by a company owner is not dissimilar to a loan to the company. Therefore, Fuller calculated interest each year on Hood's calculated undercompensation.

The Fuller report contained two opinions. In the first opinion ("the primary opinion"), Fuller concluded reasonable compensation for Hood to be $3,681,269 for the 2015 tax year and $1,362,831 for the 2016 tax year. As part of this determination, Fuller included compensation to Hood for the surety bond guaranties.

The second opinion ("the alternative opinion") excluded compensation for the surety bond guaranties. This is because Fuller noted that the PAS survey may have already included such guaranties in the construction industry data for a company board chairman. The alternative opinion ultimately concluded reasonable compensation for Hood to be $2,202,063 for the 2015 tax year and $1,314,500 for the 2016 tax year.

Of course, CHI disagreed with Fuller's opinion and asked the Tax Court to reject Fuller's report in its entirety. One of the principal reasons that CHI presented to justify its request is the allegation that the Fuller report was "statistically invalid." This allegation was because Fuller used data from the RMA and PAS survey services.

The Tax Court noted that the CHI expert witness Sharp admitted there is no such thing as "perfect data" when it comes to executive compensation. The Tax Court did not find these data services to be intrinsically defective or inappropriate for the purposes at hand. The court noted that the CHI other expert witness, Kursh, also relied on RMA data in the BLDS report. And, the CHI independent accountant, Greenway, used PAS survey data, which the CHI CFO had found to be "helpful."

Accordingly, the Tax Court concluded, "Therefore, while such benchmark data may not be as statistically exacting as petitioner would like, petitioner did not provide satisfactory countervailing evidence through its expert witness that would credibly support a greater allowable amount. In this absence, we are left looking to Mr. Fuller's report as the most credible and complete source of data, analyses, and conclusions in the record regarding what similar companies might be willing to pay Mr. Hood on petitioner's facts."

Did Hood Provide Extraordinary or Unique Services?

At trial, CHI claimed that Hood's role in the company's growth and success should be seen as extraordinary or unique such that the Tax Court should place less reliance on industry comparisons.

In response to this taxpayer position, the Tax Court concluded, "We agree with petitioner that Mr. Hood is extraordinarily talented in his industry and that perhaps few other individuals could have achieved similar results for petitioner during the later years of the review period. However, petitioner fails to appreciate that these considerations were taken into account in the expert witnesses' reports. Mr. Fuller's report specifically placed petitioner's performance in the highest tier group of its comparable industry peers for years 2013 to 2016. Accordingly, we see no reason to discount reports that already sufficiently factor in Mr. Hood's extraordinary contributions to petitioner."

The CHI Salary Policy as to All Other Employees

Certain federal courts have considered salaries paid to other employees of a private company in deciding whether executive/shareholder compensation is reasonable. In the *Hood* matter, the Tax Court also looked to this factor to determine whether Hood was compensated differently from the other CHI employees solely because of his status as a shareholder.

CHI had no structured system in place for the setting of its nonshareholder employee compensation. Hood personally set the salary and the bonus amounts of other employees and officers. At trial, Hood testified that he based these decisions on his own subjective belief as to the individual's "work records," "ability to get along with people," and "pride in the company."

Hood's salary and bonus in the tax years at issue represented almost 90 percent of the total amount of compensation that CHI paid to its officers, despite the fact that nonshareholder officers such as Painter and Addley worked nearly the same number of hours as Hood and shared many of Hood's responsibilities.

CHI had no agreement in place with Hood regarding his compensation. Instead, Hood's compensation during the review period was set by him along with his wife in

their roles as the CHI board of directors. Therefore, the court examined the specific circumstances surrounding the setting of Hood's compensation in the tax years at issue.

The 2015 Compensation Amount

The 2015 bonus amount was initially proposed at the May 2015 meeting by Phillips, Hood, and the CHI external advisers at Elliott Davis in which the meeting participants tentatively agreed on a catch up bonus amount of $5 million for Hood. In arriving at this bonus amount, CHI and its advisers had the advantage of knowing its anticipated year-end profits for the 2015 tax year. The 2015 tax year was expected to be the most successful year in its corporate history. Despite the fact that CHI never paid Hood a dividend, the company continued with its plan to award Hood a lump sum bonus.

CHI also used its own performance as a proxy for Hood's performance with the board minutes citing only overarching contributions by Hood to the company during the review period. That is, there was no attempt in the board minutes to value or quantify the specific services rendered by Hood during the review period (other than his debt guaranties).

In the *Hood* decision, the Tax Court concluded, "Such a comparison may make sense for a one-man enterprise; however, petitioner employed dozens of hardworking employees during the review period and conceded that the company's growth during this time could not be tied exclusively to Mr. Hood's efforts."

CHI did not provide evidence at trial to support what portion of the company's growth should reasonably be attached to each of the various services, including possible values thereof, rendered by Hood during the review period. In addition, CHI did not provide evidence at trial to distinguish between (1) the services provided by Hood during the review period and (2) the services provided by the company's other officers and employees.

In addition, the Tax Court provided the following observation in the Hood decision with respect to the 2015 bonus amount:

> Finally, and perhaps most telling, there was Mr. Hood's testimony during trial. When asked why he considered it acceptable to take a significant amount of money out of the company starting in the 2015 tax year despite his reluctance to do so in the past, Mr. Hood admitted that he was aware that he needed to start making necessary preparations from an "income tax" perspective in "getting money out of" the company in anticipation of "a changing of the guard.

The 2016 Compensation Amount

In awarding Hood the 2016 bonus amount, CHI acted under the awareness that, on the basis of its preliminary financials, its 2016 fiscal year was to be even more profitable than its 2015 fiscal year. Nevertheless, the CHI board again chose not to declare a dividend. Instead, the CHI board rewarded Hood exclusively through another $5 million bonus, reciting the same underlying rationale it provided for the 2015 amount. In addition, CHI made no attempt to explain why the 2015 bonus amount had been insufficient catch-up compensation for Hood's prior services during the review period.

The Tax Court noted that the trial record did not indicate that (1) when it awarded Hood the 2015 bonus amount, the CHI board believed that Hood remained undercompensated or (2) additional catch-up compensation may be warranted in the future for these prior services.

In the *Hood* decision, the Tax Court noted that, "Petitioner nevertheless attempts to distinguish its legal effect by asking us to apply section 1.162-7(b)(2), Income Tax Regs., to a portion of the 2016 amount. This regulation provides that if contingent compensation is paid under a free bargain between an employer and employee before the services are rendered, then the purported compensation amount should be allowed as a deduction even though it may be greater than what may ordinarily be paid."

In the *Hood* decision, the Tax Court also noted that, "There is little to no evidence that a bargain as envisioned under this regulation existed between petitioner and Mr. Hood with respect to any portion of the 2016 amount." That is, no written management services agreement outlining an understanding between CHI and Hood existed regarding Hood's potential total compensation for the 2016 tax year. And, CHI did not establish that its board of directors considered any part of the 2016 bonus amount at the May 2015 meeting, that is, before the commencement of Hood's 2016 performance.

Analysis of Hood's Prior Compensation Amounts

Where a large salary increase is an issue (as in the *Hood* matter), it may be helpful for the analyst to compare past and present duties and salary payments. Such a comparison may help the analyst determine whether and to what extent the current payments represent compensation for services performed in prior years that can be currently deductible.

Hood's total compensation increased over 300 percent in the CHI 2015 fiscal year, its most profitable year to date. Nonetheless, there was no corresponding

increase in Hood's duties or responsibilities in that year. According to the CHI corporate minutes, the stated justification for this increase is that Hood was undercompensated in prior years. In the Hood decision, the Tax Court addressed this issue as follows: "While we do not disagree that Mr. Hood was undercompensated in certain years of the review period, this does not entitle petitioner to carte blanche in deducting Mr. Hood's backpay bonus amount."

In addition, the Tax Court expressed concern that CHI did not sufficiently demonstrate through reliable means how the full amount of each of the 2015 and the 2016 bonus amounts was proportionate in value to each of the past services allegedly rendered by Hood.

Hood's Personal Guaranty of the CHI Debts and Bonding Obligations

The CHI justification for Hood's higher compensation for the tax years at issue included Hood's debt guaranties and surety bond guaranties during the review period. Guaranty fees may qualify as a deductible business expense under Section 162(a).

In various judicial decisions, the Tax Court has considered some of the following factors when deciding the deductibility of such fees paid to a private company executive/shareholder: (1) whether the fees were reasonable in amount given the financial risks, (2) whether companies of the same type and size as the taxpayer customarily pay such fees to shareholders, (3) whether the executive/shareholder demanded compensation for the guaranty, (4) whether the taxpayer had sufficient profits to pay a dividend but failed to do so, and (5) whether the purported guaranty fees were proportional to the executive/shareholder's stock ownership.

The Tax Court noted that (1) it is customary for the owners of construction companies to guarantee debts and bonds and (2) compensation for these guaranties is appropriate. Further, the Service's expert witness, Fuller, testified the compensation that CHI paid to Hood for surety bond guaranties in the tax years at issue was reasonable.

Regardless of this issue, the Tax Court concluded, "We recognize that Mr. Hood historically did not seek compensation for the guaranties and petitioner had sufficient profits to pay a dividend during the years at issue; however, we place more weight on the customary nature and reasonableness of the fees."

The Hood Decision Reasonable Compensation Conclusion

Considering the totality of the factors discussed above, the Tax Court concluded that CHI did not adequately establish how the total compensation amounts paid to Hood during the tax years at issue were both (1) reasonable and (2) paid solely as compensation for his services to the company during the review period. While certain factors favored the taxpayer CHI, the court did not simply sum which party had the most factors in reaching its conclusion. In the court's analysis, all factors were not afforded equal weight.

In reaching its final conclusion, the Tax Court described that the factors addressing comparable pay by comparable companies, the CHI shareholder distribution history, the setting of Hood's compensation in the tax years at issue, and Hood's involvement in the CHI business were the most relevant and persuasive factors.

In concluding the appropriate reasonable compensation amount, the Tax Court found Fuller's expert testimony to be most helpful. The Service's expert Fuller considered the multifactor approach, included compensation for the surety bond guaranties. And, Fuller offered a well-reasoned comparison of CHI and Hood's salary against industry standards. Accordingly, the Tax Court allowed a reasonable compensation tax deduction for amounts paid to Clary Hood of $3,681,269 for tax year 2015 and $1,362,831 for tax year 2016.

The Section 6662 Penalties

According to Sections 6662(a) and (b)(2), a 20 percent penalty applies to any portion of an underpayment of tax required to be reported on a tax return that is attributable to a substantial understatement of income tax (i.e., "the reported substantial understatement penalty"). According to Section 6662(d)(1)(B), for a C corporation like CHI, a substantial understatement of income tax is an understatement that exceeds the lesser of (1) 10 percent of the tax required to be reported on the tax return for the taxable year (or, if greater, $10,000) or (2) $10,000,000.

With regard to the *Hood* matter, the understatements for the years at issue qualified as "substantial" within the meaning of Section 6662(d)(1)(B). That is because each understatement exceeded 10 percent of the tax required to be reported on the CHI tax return for that tax year.

With Reasonable Cause and in Good Faith Exception

According to Section 6664(c)(1), the substantial understatement penalty does not apply with respect to any portion of an underpayment to which a taxpayer acted "with reasonable cause and in good faith." According to Regulation 1.6664-4(b)(1), whether a taxpayer acted with reasonable cause and in good faith is decided on a case-

by-case basis, taking into account all pertinent facts and circumstances.

A defense of reasonable cause requires that the taxpayer exercise ordinary business care and prudence as to the disputed item. Several judicial decisions have concluded that a taxpayer's reliance on professional advice may sometimes meet this standard.

For a taxpayer to reasonably rely upon professional advice to negate a substantial understatement penalty, the taxpayer has to prove by a preponderance of the evidence that (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment.

With regard to this issue, the *Hood* decision stated, "In cases involving corporations, we look at the efforts of a corporate taxpayer's relevant decision makers, officers, and employees to ascertain the corporation's proper tax liability in determining whether the taxpayer meets this standard."

The 2015 Penalty Amount and a Competent Professional with Sufficient Expertise

CHI sought advice on the amount of Hood's compensation and on the applicable tax consequences from Greenway and Stokes at the Elliott Davis accounting firm. Greenway was an Elliott Davis audit partner for nearly 18 years with more than 30 years of public accounting experience. As head of the Elliott Davis construction practice group, Greenway had a history of working with CHI before the years at issue, and Greenway was familiar with the comparative performance and profitability of CHI against its industry peers through his "hundreds of [other] construction clients." Greenway testified at trial that he considered at least two construction industry executive compensation surveys in connection with the advice he provided to CHI regarding Hood's compensation.

As an Elliott Davis tax partner with almost 20 years of public accounting experience, Stokes was similarly qualified. His relevant experience included (1) guiding at least 20 other clients on executive compensation matters and (2) acting as a personal tax adviser to both CHI and Hood.

Accordingly, the Tax Court concluded that the CHI advisers were adequately qualified to counsel the company on the issue of Hood's compensation and its tax implications.

Did the Taxpayer Provide Necessary and Accurate Information?

Phillips initially raised the issue of Hood's compensation with Greenway in the fall of 2014. Over the course of the next several months, Phillips performed preliminary calculations in an Excel spreadsheet. Phillips provided draft calculations to Greenway and Stokes during the May 2015 meeting. All parties agreed at that meeting that Hood deserved catch-up compensation in the form of a $5 million bonus, pending follow-up research and analysis.

As part of the follow-up due diligence, Phillips finalized his calculations on the compensation due spreadsheet. The spreadsheet included (1) certain financial information concerning CHI for each year of the review period through May 31, 2015, (2) Hood's reported compensation for each of those years, and (3) a series of items for each year labeled "Clary Hood Calculation Compensation."

Although the Service disagreed with the assumptions underlying the "Clary Hood Calculated Compensation" spreadsheet items, the Service did not claim that the data and the analyses provided by Phillips were incorrect or inadequate. And, the Service did not claim that any other CHI information should have been provided to Stokes or Greenway.

Did the Taxpayer Actually Rely on the Adviser's Judgment?

Clary and Gail Hood, as the sole members of the CHI board of directors, had limited financial and accounting knowledge. They trusted Phillips to guide them as to the issue of Hood's compensation for the years at issue. Phillips, as the company's CFO and signer of its federal income tax returns, knew the CHI financial performance and federal tax profile better than anyone at the company. However, Phillips was also inexperienced in matters of executive compensation.

Recognizing these shortcomings and wanting to ensure that CHI arrived at a reasonable amount of compensation for Hood, Phillips went to Elliott Davis for advice beginning in 2014. And, Phillips continued to discuss the issue of Hood's compensation with Elliott Davis throughout May 2015.

Following the May 2015 meeting, Stokes provided Phillips with research material summarizing the tax law on executive compensation. Stokes also reviewed the compensation due spreadsheet that Phillips created for the purpose of analyzing a potential bonus amount for Hood for the 2015 tax year. The spreadsheet was based

on CHI data and incorporated input that Phillips previously received from Greenway.

At trial, Stokes testified that he did not scrutinize each of the components underlying the comprehensive spreadsheet. However, his existing knowledge of the CHI business did not lead him to believe that any of these assumptions were unreasonable. Greenway confirmed the same conclusion at trial.

Stokes made a few modifications to the compensation due spreadsheet before sending it back to Phillips (with a copy to Hood). In his email, Stokes noted his approval of the analysis in the spreadsheet and its helpfulness in documenting the support necessary for the proposed 2015 bonus amount.

With regard to this issue, the *Hood* decision concluded, "We are satisfied that petitioner relied in good faith on the above advice when awarding Mr. Hood the 2015 amount and deducting the same for its 2015 tax year. The record does not show evidence of a rubber-stamp approval or a wink-and-a-smile by its advisers with respect to the 2015 amount."

Therefore, the Tax Court concluded the following with regard to the Section 6662 penalty to 2015: "Accordingly, we decline to sustain respondent's determination as to the accuracy-related penalty for the 2015 amount."

The 2016 Penalty Amount and Reliance on Professional Advice

CHI claimed that is also relied on professional advice in awarding Hood the 2016 bonus amount. In contrast to the detailed record surrounding the advice given to determine the 2015 bonus amount, CHI provided almost no evidence at trial with respect to the advice it may have received to determine the 2016 bonus amount.

Phillips prepared an updated compensation due spreadsheet for the 2016 bonus amount. However, there was no evidence that the CHI board of directors considered or relied on his worksheet when deciding to award Hood the 2016 bonus amount. Phillips and Stokes each testified at trial that an analysis similar to the one performed for the 2015 bonus amount was undertaken in 2016. However, the court noted that there was no evidence presented in the record of any communication between CHI and its advisers that would credibly support a finding that advice was actually rendered with respect to the 2016 bonus amount.

The Tax Court particularly noted this lack of evidence when considering that (1) in awarding Hood the 2015 bonus amount, the record did not reflect that the CHI board still believed that Hood remained entitled to additional catch-up compensation for the review period and (2) in awarding Hood the 2016 bonus amount, the CHI board minutes did not attempt to address why the 2015 bonus amount was not sufficient in this regard. Specifically, on this issue, the *Hood* decision states, "If this changing view was based on advice petitioner received during its 2016 tax year, we would need to know what that specific advice was and who provided it."

The Substantial Authority Defense

CHI also argued at trial that it has substantial authority to negate the imposition of the Section 6662 substantial understatement penalty with respect to the 2016 bonus amount. Section 6662(d)(2)(B)(k) reduces an understatement that is attributable to the tax treatment of any item for which there is (or was) substantial authority for such treatment.

According to Regulation 1.6662-4(d)(3), the substantial authority standard is objective, and therefore it is not relevant whether the taxpayer believed that the substantial authority existed.

CHI claimed that its tax return position for each tax year at issue, including the 2016 bonus amount, was based on the independent investor test. CHI claimed that two judicial decisions by the U.S. Court of Appeals for the Seventh Circuit, *Menard, Inc. v. Commissioner*[23] and *Exacto Spring Corp. v. Commissioner*[24] "provide clear cut substantial authority" for the company's use of this reasonableness of compensation test for the tax years at issue.

Regulation 1.6662-4(d)-(3)(iv(B) does permit a taxpayer to consider court cases outside of the taxpayer's home jurisdiction to establish substantial authority. However, a single Court of Appeals acceptance of a test does not necessarily equate to substantial authority.

The *Hood* decision noted that "the Court of Appeals for the Fourth Circuit, the court to which an appeal of this case would lie, see sec. 7482(b), applies the multifactor approach without consideration of a hypothetical investor and without indication that a different formulation of this test might be more appropriate."

Accordingly, the Tax Court concluded, "We therefore cannot accept the petitioner's position with respect to the 2016 amount was based on substantial authority."

Therefore, based on the above analysis, the Tax Court allowed the imposition of the Section 6662 substantial understatement penalty for the CHI 2016 tax year.

Summary and Conclusion

The U.S. Tax Court case *Clary Hood, Inc. v. Commissioner* involves a closely held C corporation's dispute

regarding the reasonableness of executive/shareholder compensation tax deductions. There was no dispute in this litigation that CHI was an extremely successful specialty construction company during the tax years at issue. And, there was no dispute in this litigation that Clary Hood, the company CEO and (with his wife) shareholder, was largely responsible for the construction company's success during the tax years at issue. The disputed issue in the litigation was whether bonuses paid to Hood in 2015 and 2016 exceed a reasonable amount of executive compensation for the services Hood actually performed for the company.

In its memorandum decision, the Tax Court provided a fulsome discussion of the methodology and analysis it applied in addressing this reasonableness of executive/shareholder compensation issue. This judicial discussion should provide meaningful guidance to private company owners and to their legal, accounting, and compensation consultant advisers.

While this judicial guidance regarding reasonableness of compensation analysis is directly applicable to federal income tax matters, it may also be helpful with regard to family law, shareholder litigation, ERISA compliance, not-for-profit entity regulatory compliance, and other matters involving the question of reasonableness of executive or professional compensation.

In particular, the *Hood* decision describes what the Tax Court liked—and disliked—about the expert testimony provided by the experts for both the taxpayer and the Service. That judicial description should provide meaningful practical guidance to forensic accountants and other financial advisers who provide testifying expert services. That judicial assessment of expert testimony and of expert reports is directly applicable to federal income tax disputes. It may also be helpful to testifying experts—and to legal counsel and litigants—involved in other types of commercial disputes.

Finally, the *Hood* decision provides a comprehensive discussion of the court's analysis regarding the application of the Section 6662 substantial understatement penalty. That discussion should be instructive to both individual and corporate taxpayers and to their tax counsel and other tax advisers.

Notes:

1. Cozart Packing Co. v. Commissioner, T.C. Memo. 1972-175, aff'd, 475 F.2d 1339 (4th Cir. 1973).
2. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992).
3. Martens v. Commissioner, 934 F.2d 319, 1991 WL 87160, at *8 (4th Cir. 1991), aff'g per curiam T.C. Memo. 1990-42.
4. Am. Sav. Bank v. Commissioner, 56 T.C. 828, 843 (197).
5. Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119 (1930), aff'g Ox Fibre Brush Co. v. Blair, 32 F.2d 42 (4th Cir. 1929, rev'g 8 B.T.A.. 422 (1927).
6. R.J. Nicoll Co. v. Commissioner, 59 T.C. 37, 50 (1972).
7. Estate of Wallace v. Commissioner, 95 T.C. 525, 553-554, aff'd 965 F.2 1038 (11th Cir. 1992).
8. Richlands Med. Ass'n v. Commissioner, 953 F.2d 639, 1992 WL 14603, at *2 (4th Cir. 1992), aff'g per curiam T.C. Memo. 1990-660.
9. Estate of Wallace v. Commissioner, 95 T.C. at 556.
10. Richlands Med. Ass'n v. Commissioner, 1992 WL 14603, at *2.
11. Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949), rev'g and remanding a Tax Court Memorandum Opinion dated November 16, 1948).
12. E.J. Harrison & Sons, Inc. v. Commissioner, T.C. Memo. 2003-239, 2003 WL 21921049, at *14-*16, aff'd in part, rev'd in part, and remanded on another issue, 138 F. App'x 994 (9th Cir. 2005).
13. Martens v. Commissioner, 1991 WL 87160, at *9.
14. Medina v. Commissioner, T.C. Memo. 1983-253.
15. Metro Leasing & Dev. Corp. v. Commissioner, 326 F.3d 1, 3-4 (1st Cir. 2003), aff'g T.C. Memo. 2001-119, 2001 WL 530694 and 119 T.C. 8 (2002).
16. Haffner's Serv. Stations, Inc. v. Commissioner, 326 F.3D, 1-3 (1st Cir. 2003), aff'g T.C. Memo. 2002-38.
17. Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).
18. Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1245 (9th Cir. 1983), rev'g T.C. Memo. 1980-282.
19. Pepsi-Cola Bottling Co. of Salina v. Commissioner, 61 T.C. 564, 567 (1974), aff'd, 528 F.2d 176, 179 (10th Cir. 1975).
20. Beiner, Inc. v. Commissioner, T.C. Memo. 2004-219, 2004 WL 2164888.
21. Metro Leasing & Dev. Corp. v. Commissioner, 2001 WL 530694.
22. Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd 445 F.2d 985 (10th Cir. 1971).
23. Menard, Inc. v. Commissioner, 560 F.3d 620 (7th Cir. 2009), rev'g T.C. Memo. 2004-207.
24. Exacto Spring Corp. v. Commissioner, 196 F.3d, 833.

Robert Reilly is a managing director in our Chicago practice office. He can be reached at (773) 399-4318 or at rfreilly@willamette.com.

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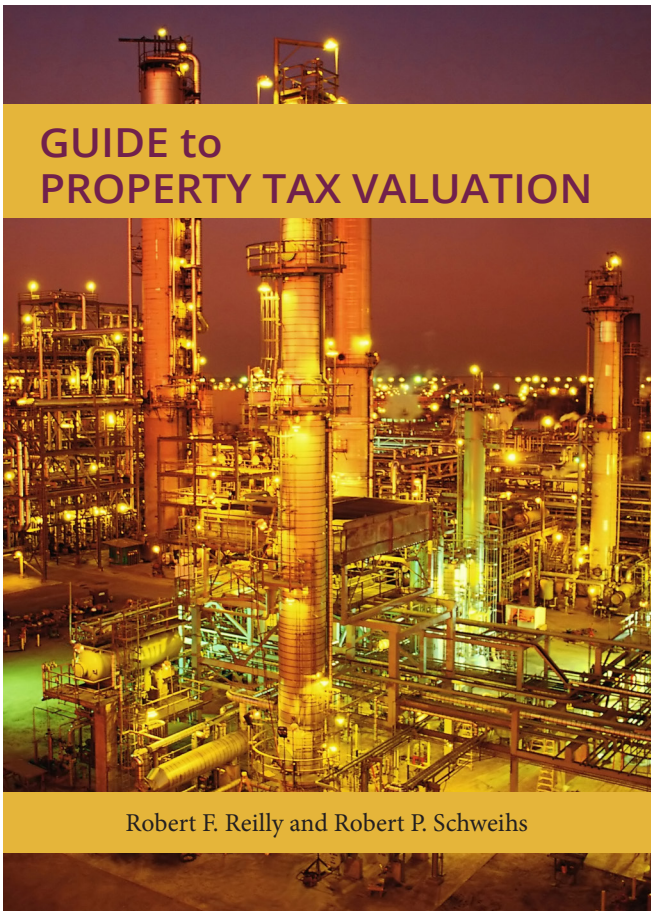

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GUIDE TO PROPERTY TAX VALUATION

Robert F. Reilly and Robert P. Schweihs

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Who Should Buy This "Must-Have" Book

- Tax directors and tax managers of taxpayer corporations
- State and local tax assessors
- Property owners of centrally assessed or locally assessed real estate and personal property
- Lawyers who practice in the state and local tax area
- Valuation analysts who prepare valuation analyses and valuation reports for ad valorem tax compliance, appeal, or litigation purposes
- Property tax consultants

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On Our Website

Recent Articles and Presentations

Robert F. Reilly, a managing director of our firm, authored an article that was published in the November 2022 issue of ALI CLE's Practical Tax Lawyer. The title of Robert's article is "Subjective Determination and Objective Determination for Claiming a Worthless Security Loss Deduction"

Tax counsel often advise taxpayers to apply Internal Revenue Code Section 165(a) to claim an income tax deduction for an uncompensated loss sustained during the tax year. The tax character of the uncompensated loss can be an ordinary income deduction or a capital loss, depending on the facts and circumstances. Robert's article illustrates that the Section 165(a) worthless stock deduction is not limited to the stock of a corporation, but is also available for a partnership interest, LLC interest, or similar equity interests. Robert describes the criteria that tax counsel and the Internal Revenue Service consider to determine the worthlessness of a security.

Robert F. Reilly authored another article that was published in the November 2022 issue of ALI CLE's Practical Tax Lawyer. The title of Robert's second article is "Income Tax Consequences Related to Commercial Damages Awards."

Robert's article focuses entirely on commercial damages measurement issues—not on causation or liability issues. In particular, his article focuses on one technical, but important, issue related to the measurement of the amount of commercial damages: the income tax considerations related to the damages measurement. These income tax considerations relate to: (1) the income recognition and the taxation of any compensation-related payments received by the damaged party; (2) the tax deduction and the taxation of any compensation-related payments made by the damaging party; and (3) the measurement of the amount of the judicial award (or the negotiated settlement) required to make the damaged party whole—after any adjustments necessary with regard to the related income tax considerations. In addition, Robert's article discusses what the tax counsel—and the damaged/damaging company, the company owners, litigation counsel for these parties, and each party's damages analyst—need to know about the income tax considerations related to damages measurements and damages awards (or negotiated settlements).

Robert F. Reilly delivered a presentation at the Annual Conference of the Minnesota Chapter of the National Association of Certified Valuators and Analysts. The conference was held on September 21, 2022. The title of Robert's presentation is "Best Practice for Avoiding Common Errors in Fair Value Measurements."

Robert's presentation begins with an overview of fair value measurement issues. He then discusses the top 10 fair value measurement errors and omissions and best practices for avoiding these errors. Robert goes on to explore best practices for other fair value measurement issues and general valuation analyst caveats and best practices.

Robert F. Reilly delivered a presentation at the National Association of Property Tax Representatives—Transportation, Energy, and Communications (NAPTR-TEC) 2022 Conference, which was held on October 25, 2022, in Kansas City, Missouri. The title of Robert's presentation is "Best Practices for Economic Obsolescence Measurement and Reporting."

Robert's presentation begins by introducing unit principle property appraisal concepts and economic obsolescence concepts. He then explores the principles of economic obsolescence measurement. Robert discusses generally accepted economic obsolescence measurement methods. He presents 25 (or so) best practice responses to objections to economic obsolescence measurements. Finally, he reviews assessment authority considerations regarding obsolescence adjustments. This version of Robert's presentation is expanded from the handout given at the conference.

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Communiqué

In Print

Robert Reilly, Chicago office managing director, authored a four-part article that was published in the National Association of Certified Valuators and Analysts online publication *QuickRead*. *QuickRead* is located at www.quickreadbuzz.com. The title of the four-part article was "Best Practices for Bankruptcy-Related Property Appraisals."

Part I appeared in the September 21, 2022, *QuickRead* issue. Part II appeared in the September 28, 2022, *QuickRead* issue. Part III appeared in the October 6, 2022, *QuickRead* issue. And, Part IV appeared in the October 13, 2022, *QuickRead* issue.

Robert Reilly authored an article that was published in the May/June 2022 issue of the Thomson Reuters journal *Construction Accounting and Taxation*. The title of Robert's article was "Income Tax Consequences regarding Damages Awards."

Robert Reilly also authored an article that was published in the July/August 2022 issue of *Construction Accounting and Taxation*. The title of that journal article was "Criteria for Claiming a Worthless Security Loss Deduction."

Robert Reilly authored an article that was published in the November 2022 issue of the Thomson Reuters journal *Practical Tax Strategies*. The title of Robert's article was "Ownership Restrictions and Other Negative Influences on S Corporation Business and Stock Valuations."

Robert Reilly authored two articles that were published in the September 2022 issue of *The Practical Tax Journal,* a publication of the American Law Institute Continuing Legal Education. The title of Robert's first article was "Taxation Considerations Related to Equity Incentive Plans." The title of Robert's second article was "Noncompete Agreement Tax Considerations in Corporate Acquisitions."

Robert Reilly also authored two articles that were published in the November 2022 issue of *The Practical Tax Journal*. The title of Robert's first article was "Income Tax Consequences Related to Commercial Damages Awards." The title of Robert's second article was "Subjective Determination and Objective Determination for Claiming a Worthless Security Loss Deduction."

In Person

Robert Reilly delivered a presentation to the National Association of Certified Valuators and Analysts ("NACVA") Annual Business Valuation and Financial Litigation Conference in August 2022. The title of Robert's NACVA conference presentation was "Asset-Based Approach to Business Valuation—Conceptual Foundations and Practical Applications."

Robert Reilly also delivered a presentation to the NACVA Minnesota chapter's Annual Business Valuation Conference in September 2022. The title of Robert's presentation was "Fair Value Issues—Avoiding Common Errors in the Development and Reporting of Fair Value Measurements."

Robert Reilly delivered a presentation to the National Association of Property Tax Representatives —Transportation, Energy, and Communications ("NAPTR-TEC") annual conference held in Kansas City in October 2022. The title of Robert's NAPTR-TEC conference presentation was "Best Practices for Economic Obsolescence Measurement and Reporting."

An expanded version of Robert's NAPTR-TEC conference presentation materials (including a bibliography of book and journal articles related to property-tax-related economic obsolescence measurement issues) is available on the Willamette Management Associates website at www.willamette.com/NAPTR-TEC.

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Thought Leadership in Intellectual Property Valuation, Damages, and Transfer Price Analyses

❑ Autumn Issue 2020

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❑ Summer Issue 2022

Thought Leadership in Professional Practices and Licenses Valuation, Damages, and Transfer Price Analyses

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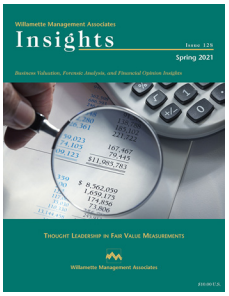

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Willamette Management Associates
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Chicago Office
8600 West Bryn Mawr Avenue
Suite 950-N
Chicago, IL 60631
(773) 399-4300
(773) 399-4310 (FAX)

Portland Office
111 S.W. Fifth Avenue
Suite 1900
Portland, OR 97204
(503) 222-0577
(503) 222-7392 (FAX)

Atlanta Office
1355 Peachtree Street, N.E.
Suite 1470
Atlanta, GA 30309
(404) 475-2300
(404) 475-2310 (FAX)