Willamette Management Associates

Insights

Issue 127

Winter 2021

Business Valuation, Forensic Analysis, and Financial Opinion Insights

Thought Leadership in Estate and Gift Transfer Tax Valuation Matters

Willamette Management Associates

$10.00 U.S.

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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.

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

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Thought Leadership in Estate and Gift Transfer Tax Valuation Matters
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Forethoughts

Wealth planning is an important consideration for the estates and trusts of many high net worth individuals and families. These estates and trusts often own private businesses, business ownership interests, and/or intangible assets. Such business interests often require independent fair market value valuations in order to achieve the specific plans, goals, and objectives of the individual or family. This *Insights* issue expands on the more than 50-year history of Willamette Management Associates thought leadership and experience assisting high net worth individuals, private family businesses, legal counsel, and wealth advisers with valuation services for gift and estate planning and compliance purposes.

This *Insights* issue presents observations regarding the economic impact from the COVID-19 pandemic and discusses analyst considerations for estimating the fair market value of a private business or business interest during periods of economic uncertainty for gift and estate tax planning and compliance purposes. This *Insights* issue also provides perspectives on what tax counsel need to know about working with a valuation specialist and on analyst considerations for applying a discount for lack of control in transfer tax valuations. This issue discusses the consideration of subsequent events in the valuation of businesses, business interests, and intangible assets for gift and estate tax purposes. Other discussions consider conducting valuation-related due diligence interviews of the owners and managers of the privately held business for transfer tax purposes. Consistent with this focus on privately held businesses, this issue summarizes various types of available stock-based compensation plans for the private business to attract and retain key employees.

This *Insights* issue also addresses best practices for an analyst performing a functional analysis as one part of a valuation, damages, or a transfer price analysis. This *Insights* issue concludes with discussions of recent Tax Court decisions, including takeaways from *Pierson M. Grieve v. Commissioner* (T.C. Memo. 2020-28).

About the Editor

Michael L. Binz

Michael Binz is a managing director with Willamette Management Associates, and he provides valuation advisory and financial consulting services related to the valuation of closely held business entities and business interests, assets and securities, intangible assets, and intellectual property. Mike also has extensive experience preparing and reviewing valuations for financial reporting purposes under both U.S. generally accepted accounting principles and international financial reporting standards.

He practices predominantly in the firm's wealth management valuation services discipline and provides valuation services related to wealth transfer planning, estate and gift tax, generation skipping tax, damages claims, buy-sell agreements, intangible assets, mergers and acquisitions, fairness opinions, solvency analyses, and damages measurement analyses. He has provided expert testimony in federal court, various state courts, and in alternate dispute resolution settings—including arbitration and mediation.

Mike has significant experience in the valuation of various types of business entities and interests, including family-owned businesses, employee-owned businesses, noncontrolling ownership interests, tangible and intangible assets, public company restricted stock, large blocks of publicly traded securities, preferred stock, debt securities, general and limited partnership interests, limited liability company membership interests, professional practices, joint ventures, licensing agreements, and foreign domiciled entities.

Prior to joining Willamette Management Associates, Mike spent 26 years in Big-4 public accounting, providing valuation services to both private and public companies. Mike is an accredited senior appraiser in business valuation, accredited by the American Society of Appraisers, and he holds the accredited in business valuation designation from the American Institute of Certified Public Accountants.

Thought Leadership Discussion

Valuation Considerations for Gift and Estate Tax Planning and Compliance Purposes during Economic Uncertainty

Michael L. Binz

The valuation of a privately held business or business ownership interest becomes more complex during periods of economic uncertainty. This discussion summarizes observations from recent events affecting global economies, and it focuses on the implications for gift and estate tax valuations. Understanding the economic outlook at the specific valuation date establishes the context for valuation analysts and regulatory agencies to assess expectations regarding future performance of a privately held business or business interest. This discussion presents several factors that analysts may consider when estimating fair market value for gift and estate tax purposes during economic uncertainty. The current environment may provide an opportunity for the owners of private businesses and business interests to evaluate their wealth planning goals, strategies, and objectives in order to maximize future benefits.

Introduction

Uncertainty is generally thought of as a state of doubt. It applies to predictions of future events, to physical measurements that are already made, or to the unknown.[1]

In today's economic environment, businesses—particularly private businesses—are faced with multiple challenges. These challenges fill the business landscape with risk and uncertainty and are driven by:

1. the public health crisis and
2. the ensuing economic fallout.

Global Pandemic

Since the beginning of March 2020, the impact of the global pandemic has been felt across the world. According to the Center for Systems Science and Engineering at Johns Hopkins University, as of September 23, 2020, there were more than 31.7 million coronavirus cases reported with 972,000 deaths across the globe.

In the United States, the number of cases now exceeds 7 million with over 210,000 deaths. While these statistics are grim, the impact to U.S. businesses has also become alarming. An estimated 80,000 small businesses were permanently closed between March 1, 2020, and July 25, 2020.[2]

As the virus spread, many businesses considered nonessential were forced to temporarily close, resulting in a spike to the U.S. unemployment rate. Travel restrictions and social distancing protocols further compounded the contraction in economic activity throughout the United States.

While the full economic and social impact of the global pandemic may not be known for years, the implications from the temporary lack of activity are far reaching. The uncertainty of the outcome from the pandemic may have rippling effects as individuals and businesses may find it difficult to borrow funds from traditional sources as credit tightens. Households may postpone major purchases and businesses may delay investment decisions creating additional economic uncertainty.

While the vast majority of Americans hope the economy will quickly rebound and return to growth, there is no guarantee. As the time line for an effective vaccine and further economic stimulus remain in question, businesses will likely:

1. endure longer periods of uncertainty and
2. face increased exposure to risk.

Many businesses in fragile industries may not survive or ever return; others may find ways to adapt and prosper. In the near term, as existing restrictions are eased and activity levels increase, the threat of possible resurgence of the virus could jeopardize economic recovery or even push the U.S. economy into a double-dip recession.

Impact on U.S. Markets

To understand the impact of the pandemic on U.S. markets, Exhibit 1 presents selected capital market data before and after the onset of COVID-19. Trailing 2019 statistics reflect solid economic growth and strength with market indices approaching record levels before peaking in February.

The data illustrate significant volatility from the market peak (February 19, 2020) to the declaration of public health emergencies throughout the United States. Investor reaction was swift as the S&P 500 decreased 34 percent to its low on March 23, 2020.

The average implied S&P price to earnings ("P/E") multiples decreased as much as 25 percent and the yield on U.S. 20-year Treasury securities, a proxy for the risk-free rate, declined 41 percent. After initial declines, markets and P/E multiples rebounded but remain volatile.

According to the U.S. Bureau of Economic Analysis, real gross domestic product ("GDP"), decreased at an annual rate of 4.8 percent during the first quarter of 2020 and was attributed to the effects of the partial economic shut-down from the pandemic, marking the largest decrease since the last recession and the first decrease since 2014.

This decline reflected negative contributions from personal consumption expenditures, nonresidential fixed investment, exports, and private inventory investment, and were partly offset by positive contributions from residential fixed investment and government spending.[3]

Exhibit 1
Selected Capital Market Data before and after the Outbreak of COVID-19

	2019		2020		
Index	March 29	June 28	DJIA Peak	March 27	June 29
Dow Jones Industrial Average	25,928.68	26,599.96	29,551.42	21,636.78	25,015.55
U.S. 20 Year Treasury Securities	2.63	2.31	1.86	1.09	1.16
S&P Industrials	3,843.88	3,975.71	4,595.26	3,500.45	4,246.85
P/E Multiple	24.5	23.9	28.5	21.8	26.7
Dividend Yield	1.85	1.83	1.67	2.15	1.92
S&P 500 Composite	2,834.40	2,941.76	3,380.16	2,541.47	3,009.05
P/E Multiple	21.7	22.2	25.4	19.1	21.6
Dividend Yield	2.00	1.97	1.81	2.38	1.69
Nasdaq Composite	7,729.32	8,006.24	9,731.18	7,502.38	9,757.22

Sources: *Barron's (* 4-1-19, 7-1-19, 2-17-20, 3-30-20, and 6-29-20) and U.S. Department of Treasury (4-1-19, 7-1-19, 2-17-20, 3-30-20, and 6-29-20).

Valuation Considerations for Gift and Estate Tax Planning and Compliance

The following discussion presents considerations related to the valuation of a privately held business or business interest during periods of economic uncertainty. This discussion highlights definitions and guidance that are often referenced by valuation analysts.

This discussion also includes a summary of generally accepted valuation approaches and discount rates A detailed discussion of all business valuation approaches and methods, discount rates and capitalization rates, and market pricing multiples is beyond the scope of this discussion.

Business valuations used for gift and estate tax purposes should adhere to the applicable provisions of the Internal Revenue Code ("Code") and the Treasury regulations.

Regulation 20.231-2 states "in valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods and factors which must be considered in valuing such securities are outlined."

Business valuations performed for federal gift and estate tax purposes typically follow the factors listed in Internal Revenue Service Revenue Ruling 59-60. This revenue ruling states that the following factors are fundamental and should be considered in each case:

1. The nature of the business and the history of the enterprise from its inception
2. The economic outlook in general and the condition and outlook of the specific industry in particular
3. The book value of the stock and the financial condition of the business
4. The earning capacity of the company
5. The dividend-paying capacity
6. Whether or not the enterprise has goodwill or other intangible value
7. Sales of the stock and the size of the block of stock to be valued
8. Having their stocks actively traded in a free and open market, either on exchange or over the counter

As specified in Revenue Ruling 59-60, the fundamental factors considered in the gift-or-estate-tax-related valuation of a privately held business or business interest include consideration of the following factors as of the relevant valuation date:

1. The economic outlook
2. The condition and outlook for the specific industry

For gift tax purposes, the valuation date is the date of the taxable transfer. And, for estate tax purposes, the valuation date is the date of death or the alternative valuation date, six months following the date of death.

The valuation date defines the "overarching context in which the subject interest of the valuation is interacting with and affected by the internal and external environments to which the subject interest is exposed. There is significant consensus in the valuation profession that the as-of date defines the boundary between observable, measurable history and hypothetical expectations of the future."[4]

When conducting business valuation assignments, analysts gather, review, analyze, and compare large amounts of data within the context of the valuation date. Part of this diligence process may involve management interviews to gather facts about operations, competitive position, financial performance, and business plans. These interviews are generally conducted within the context of the valuation date to confirm what was known or knowable as of the valuation date.

To the extent management-prepared financial projections are provided by the private company, analysts should validate the process used to develop the projections—including the date the financial projections were prepared.

Valuations used for gift and estate tax planning and compliance purposes generally do not consider events and data[5] past the valuation date unless these events and data were known or knowable.

Because some businesses periodically update projections as part of the financial reporting process or as required by lenders or outside investors, analysts should understand and confirm the date the projections were prepared and confirm what was known or knowable as of the valuation date. In the current economic environment, analysts will need to understand what information about COVID-19 was known or knowable as of the valuation date.

The American Institute of Certified Public Accountants ("AICPA") Coronavirus (COVID-19) Resource Center suggests that information known about the coronavirus as of a specific date will likely be the subject of debate, and that information about the virus can be viewed at the date the virus was known to exist and the date when the virus affected the U.S. economy.

The AICPA further suggests these dates represent at least two different dates that the analyst will need to consider in developing and justifying assumptions used and considered in the valuation report.

However, if the valuation date is prior to the onset of the pandemic and if the intended user of the valuation considers information or events after the valuation date to be important and meaningful, then the valuation analyst may consider disclosing that information or events.

In developing fair market value estimates for privately held businesses or business interests, analysts consider the three generally accepted business valuation approaches: the income approach, the market approach, and the asset-based approach. Within each approach there are accepted methods, practices, and procedures for the application of each approach.

Valuations of privately held businesses or business interests prepared for gift and estate tax planning and compliance purposes can involve operating entities or holding companies. The fair market value of operating entities are often estimated by applying the market approach and the income approach, while the fair market value of asset holding companies is often estimated by applying the asset-based approach.

In the case of an operating company, the market approach considers the application of market multiples derived from guideline publicly traded companies and/or guideline company transactions operating the same or similar industry with similar characteristics. The income approach generally includes the application of a present value discount rate or a direct income capitalization rate.

When applying the income approach, the analyst may apply a present value discount rate or a direct capitalization rate depending on the income, earnings, or cash flow and selected method used in the valuation. A discount rate is defined as a rate of return used to convert a monetary sum, payable or receivable in the future into present value.[6]

A discount rate is also defined as the rate used to calculate the present value of earnings or cash flow at a specific point in time. In developing discount rates, certain components are developed from the analysis of market-derived data (e.g., risk-free rate, equity risk premium, size premium) as of the valuation date while other factors, specifically the unsystematic risk premium or company-specific risk premium, require professional judgment.

Discount rates may be applied to different measures of income including equity-related cash flow or invested-capital-related cash flow. Analysts typically match the appropriate discount rate with the selected income or cash flow metric. For example, in the case of invested capital cash flow, analysts typically use a weighted average cost of capital, and in the case of equity cash flow, analysts estimate an equity discount rate.

Mathematically, the cost of equity capital, or an equity discount rate, is calculated as follows:

$$K_e = RF + (R_n - RF) + SARP + IARP + URP$$

where:

K_e	=	Cost of equity-equivalent capital
RF	=	A measure of the risk-free rate of return
R_n - RF	=	The long-term equity risk premium
SARP	=	The size adjustment risk premium
IARP	=	The industry adjustment risk premium
URP	=	The unsystematic or company-specific risk premium

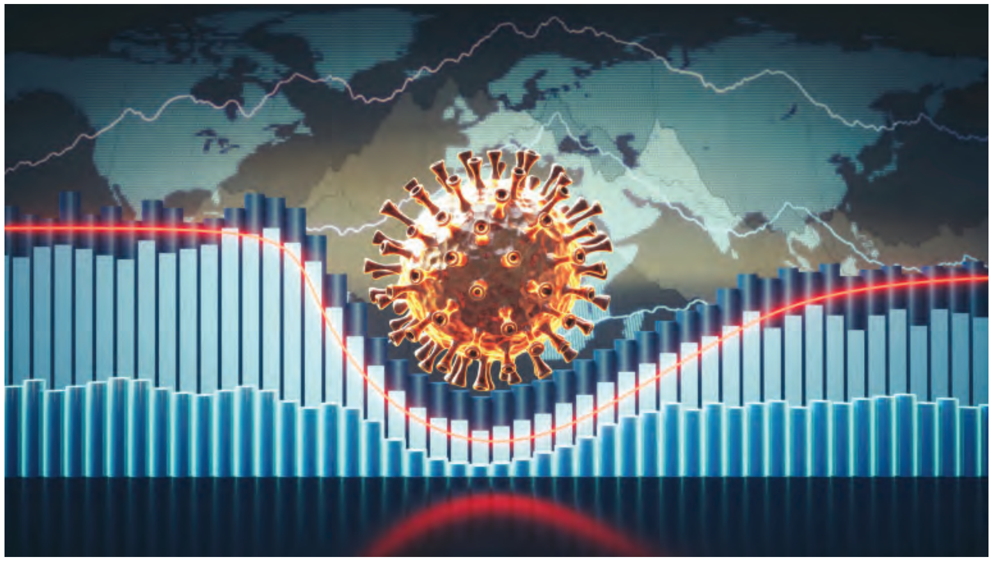
Included as a component of the cost of equity capital is the unsystematic risk or company-specific risk premium ("CSRP"). This component is intended to capture company-specific risk factors not accounted for in the size adjustment premium or industry adjustment risk premium. Analysts sometimes refer to this component as alpha, or simply as the CSRP.

The mathematical equation for the cost of equity can also be thought of in the context of risk. That is, the cost of capital for any given investment is a combination of two basic factors:[7]

1. A risk-free rate, which is a rate of return that is available in the market on an investment that is free of default risk, usually the yield to maturity on a U.S. government security
2. A premium for risk, which is an expected amount of return over and above the risk-free rate to compensate the investor for accepting risk

A generally accepted definition of risk in the context of business valuation is the degree of certainty or uncertainty as to the realization of expected returns.[8]

As the market's perception of the degree of risk of an investment goes up, the rate of return the market requires (the discount rate) goes up. The higher the market's required rate of return, the lower the present value of the investment.[9]



Valuation Considerations during Economic Uncertainty

During periods of economic uncertainty, the valuation of a privately held business or business interest may require additional diligence when estimating applicable discount rates and market-derived pricing multiples. In the current environment, the U.S. business cycle reached an inflection point and shifted from an expansion cycle to a recession cycle.

Given the significance of this economic shift, analysts may elect to consider alternative scenario analyses to ensure applicable market multiples and discount rates reflect economic uncertainty and incremental risk.

Capital market theory divides risk into two components: (1) systematic risk and (2) unsystematic risk.

Systematic risk is defined in the textbook *Valuing a Business: the Analysis and Appraisal of Closely Held Companies*,[10] as the uncertainty of future returns due to the sensitivity of the return on the subject investment to movements in the return for the investment market as a whole. Unsystematic risk is a function of characteristics of the industry, the individual company, and the type of investment interest.[11]

Systematic risk is generally considered through beta, which is measured by comparing the excess return on an individual security relative to the excess return on the market index.

Unsystematic risk is not directly observable and requires an analysis of risk factors specific to the subject business and the application of professional judgment.

Company-Specific Risk Premium

The CSRP is the risk premium associated with the level of unsystematic risk inherent in a particular business or business ownership interest. The CSRP can be positive or negative depending on the specific facts and circumstances associated with a privately held business or business interest.

The CSRP can be considered as the incremental risk premium needed to compensate an equity investor for the uncertainty of investing in a particular privately held business, business ownership interest, or intangible asset.[12]

The CSRP component of the discount rate should also be appropriately calibrated with the financial projections to avoid double-counting risk adjustments which may have already been incorporated into the projections. Analysts may also expect added scrutiny regarding CSRP given the professional judgment required and the fact that this premium has received more attention due to the economic fallout from the global pandemic.

Similarly, the selection of appropriate market multiples to reflect incremental risk may also be warranted. Analysts should also review historical financial data and consider the need for normalizing adjustments for nonrecurring items and specific adjustments to normalize the financial metrics of businesses affected by programs under the Comprehensive Aid, Relief and Economic Security ("CARES") Act. The AICPA provides further guidance for analysts when considering the impact of the CARES Act and any additional economic support programs as part of a valuation.

Analysts may consider adjustments to the CSRP based on competitive, financial, management, economic, and operational risk factors. Within these risk factors, more detailed assessments may also be considered including the following:

Competition:

- Comparative assessment of projected revenue growth, margins, earnings/cash flow relative to industry peers
- Capital structure analysis/comparison relative to competitors
- Operating leverage peer comparison
- Business and product/services life cycle analysis
- Assess competitive position with the industry (leader, follower, positive, neutral, negative)
- Consider product/service differentiation factors and assess product/service life cycle
- Industry consolidation risk
- Product line concentration/diversification risk vs. competitors
- Supply and distribution chain constraints

Financial Strength:

- Historical and current volatility in revenue, margins, earnings, and cash flow
- Impact on revenue, margins, earnings, and cash flow due to changes in the economy and industry
- Cash conversion cycle, working capital requirements
- Changes in recurring/nonrecurring revenue and earnings (historical and projected)
- Customer turnover/attrition patterns and trends
- Changes in liquidity, debt levels, and reinvestment requirements
- Operating cash requirements and use of excess cash resources
- Access to debt and equity capital resources
- Insolvency risk
- Contingent liability risk
- Business life cycle stage

Management Strength/Depth and Workforce:

- Management turnover or loss of key employee/talent
- Key person consideration
- Management business and industry experience
- Management departures and subsequent competition
- Workforce skill level requirements
- Organized labor risk factors including strikes and management lockouts

National, Regional, and Local Economic Factors:

- Macroeconomics analysis, leading economic indicators for (e.g., GDP, unemployment, interest rates, market volatility, business failure rates, etc.)
- Business cycle, expansion/recession

Operational Factors:

- Facility limitations, excess or insufficient operating capacity
- Equipment failure and backup risk
- Geographical operating limitations
- Location advantages/disadvantages

There are a multitude of company-specific risk factors analysts may consider, and the factors presented above are not intended to represent a comprehensive list of all CSRP factors. However, the appropriate identification, consideration, and weighting of company-specific risk factors should result in a premium that appropriately reflects the incremental risk related to the specific business or business ownership interest.

Quantifying the CSRP may take different forms. Some analysts rely on qualitative assessment, others may apply numerical weighting to factors considered, but CSRP quantification is also a function of professional judgement.

The National Association of Certified Valuators and Analysts ("NACVA") provides guidance with respect to company-specific risk premiums. And, NACVA recommends consideration of the similar factors presented above when estimating CSRP.

In the current economic environment, many businesses have been reassessing financial projections, analysts should closely examine these projections and may need to consider alternative scenario analyses to reflect industry supply/demand imbalance or increased volatility in revenue, profit margins, and cash flow. The results from alternative scenarios may provide additional insight and support for an appropriate range of possible conclusions.

Analysts may also investigate where a business falls in the continuum of its life cycle (e.g., new, growth, mature, decline) and further investigate the business life cycle within the context of the economic outlook and cyclical industry implications. These considerations may also influence the selection of an appropriate long-term (or terminal period) growth rate assumption.

The company-specific risk premium is considered directly in the application of the income approach when the analyst selects a discount rate or a capitalization rate for the valuation of a business ownership interest.[13]

The CSRP is also considered indirectly in the application of the market approach and the asset-based approach in the valuation of a business or business interest. To a certain extent, the magnitude of the selected CSRP may be influenced by the purpose of the business valuation.[14]

For example, the selection of the CSRP to be considered in the valuation of an equity interest for gift and estate tax transfer purposes may be influenced by the following considerations:

- The statutory, regulatory, judicial, or other standard of value selected or required for the valuation assignment (e.g., fair market value, fair value, investment value)
- The statutory, regulatory, judicial, or other level of value selected or required for the valuation assignment (e.g., controlling, marketable; noncontrolling, marketable; controlling nonmarketable; noncontrolling, nonmarketable)
- The statutory, regulatory, judicial, or other premise of value selected or required for the valuation assignment (e.g., value in continued use as a going concern, value in exchange as part of a disposition of asset)

Furthermore, in the consideration of the CSRP with regard to a specific privately held business, business ownership interest, or intangible asset as part of estate or trust, the analyst may be instructed by legal counsel regarding the relevant statutory authority, judicial precedent, or administration rulings with respect to the application of the CSRP.

The Delaware Court of Chancery (the "Chancery Court") has opined on the inclusion of the CSRP in numerous fair-value-related shareholder appraisal rights and shareholder oppression matters. In these judicial decisions, the Chancery Court has generally disallowed the inclusion of a CSRP in the cost of equity measurement for dissenting shareholder rights fair value valuations.

Noncontrolling Interest Considerations

For the privately held noncontrolling business interest, consideration of the current economic environment may affect applicable discounts for lack of control and lack of marketability based on liquidity concerns and limitations in the market. Further, as economic conditions fluctuate, the pace of merger and acquisition transaction activity may change, and control premiums could trend lower as market participants become more risk-averse to any slowdown in economic recovery or lower growth expectations in GDP.

Additional guidance from the AICPA specific to the development of a discount for lack of marketability suggests that analysts review holding periods from the perspective of a hypothetical willing buyer from the onset of the pandemic. This may affect the timing of a sale of a business or business interest which in turn may have an impact on the appropriate discount for lack of marketability.[15]

Analysis of expected growth in value over the anticipated holding period may force the elimination of dividends to bolster business liquidity and lower potential demand from noncontrolling interest investors.

Another factor to consider is how the impact from the pandemic affects the return premium investors require for enduring illiquidity. Relative to returns on publicly traded shares, an increasing premium for illiquidity would contribute to a higher discount for lack of marketability while a lower illiquidity return premium may suggest a lower discount for lack of marketability.

As is the case for all valuations, well-documented work papers and valuation reports are needed to meet the reporting requirements for the valuation of a privately held business, or business interest for gift and estate tax planning and compliance purposes.

Planning Opportunities

Wealth planning opportunities should be considered and evaluated during times of economic uncertainty. This is because valuations for private businesses or business interests may be adversely affected by the shift in the business cycle or changes in supply and demand patterns, industry trends and cycles, and the multitude of company-specific factors which may collectively increase the risk profile of a specific business.

On the cusp of the presidential election, the risk of changes to current tax provisions, including significant reduction to existing exclusion limitations or the implementation of gift and estate tax proposals by Congress, could be accelerated or materially modified by a new political regime.

Summary and Conclusion

This discussion presented observations regarding the economic fallout from the recent global pandemic. And, this discussion summarized several analyst considerations when estimating the fair market value of a privately held business or business interest for gift and estate tax planning and compliance purposes during periods of economic uncertainty.

The current economic environment has created an opportunity for individuals and families to evaluate their estate plans and consider additional wealth planning strategies.

For individuals and families seeking to maximize the benefits of the current exemption limitations for gift and estate and generation-skipping transfers of $11.58 million per individual or $23.16 million per couple, the window may be closing quickly as the November election season and the risk of potential tax law changes draws near.

Notes:

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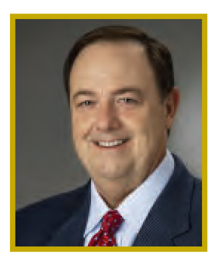
2. Madeline Ngo, "Small Businesses Are Quietly Dying by the Thousands during the Coronavirus Pandemic," *Bloomberg News* (Tribune Content Agency, August 12, 2020).
3. "Gross Domestic Product, First Quarter 2020 (Advance Estimate)," U.S. Bureau of Economic Analysis (April 29, 2020) and "Personal Income and Outlays, March 2020," U.S. Census Bureau and U.S. Bureau of Economic Analysis (April 30, 2020).
4. L. Paul Hood Jr. and Timothy R. Lee, *A Reviewer's Handbook to Business Valuation: Practical Guidance to the Use and Abuse of a Business Appraisal* (New Jersey: John Wiley & Sons, 2011), 26–27.
5. Consideration of subsequent events in a valuation are based on facts and circumstances based on legal guidance under the U.S. Tax Code, regulations to the U.S. Tax Code, and Tax Court decisions.
6. ASA Business Valuation Standards (Herndon, VA: American Society of Appraisers, 2009) and portions of *Uniform Standards of Professional Appraisal Practice* (Washington: Appraisal Foundation, 2020).
7. Shannon P. Pratt and Roger J. Grabowski, *Cost of Capital: Estimation and Applications,* 5th ed. (New York: John Wiley & Sons, Inc. 2014), 70.
8. Ibid., 71.
9. Ibid., 72.
10. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw Hill Companies, 2008), 185.
11. Ibid.
12. Connor J. Thurman and Robert F. Reilly, CPA, "The Property-Specific Risk Premium and Unit Principle Valuations, Part 1," and "Benchmarks to Estimate the Property-Specific Risk Premium Unit Principle, Part 2," *Journal of Multistate Taxation* (forthcoming).
13. Thurman and Reilly, "The Property-Specific Risk Premium and Unit Principle Valuations." CSRP may also be relevant when appraising real property, tangible personal property, and other types of illiquid investments. When applying an investment-specific risk premium in analyses where the valuation subject is not a business interest, similar considerations should be made with regard to the (1) validity of the investment-specific risk premium, (2) legal/statutory limitations on the use of the investment-specific risk premium, and (3) appropriate level of the subject investment-specific premium.
14. Ibid.
15. Ibid.

Michael Binz is a managing director in our Atlanta practice office. Mike can be reached at (404) 475-2314 or at mlbinz@willamette.com.



Due Diligence Interviews for Transfer Tax Valuation Purposes

Robert F. Reilly, CPA

Valuation analysts ("analysts") are often retained by high net worth taxpayers—and their tax counsel—to perform valuations related to transfer tax (or income tax) planning, compliance, audit, or litigation purposes. These valuations often involve private companies, private business ownership interests, or private debt and equity securities. In such valuations, the analyst typically performs various due diligence analyses. This discussion focuses on one due diligence procedure: the valuation-related due diligence interviews related to the owners and managers of the private company.

Introduction

Valuation analysts, property appraisers, forensic accountants, economists, finance consultants, industry consultants, investment bankers, and other professionals (collectively referred to herein as "analysts") are sometimes asked to conduct valuations for gift tax, estate tax, and generation-skipping transfer tax (collectively referred to herein as "transfer tax") purposes. Analysts are also sometimes asked to conduct valuations for income tax purposes.

These transfer tax and income tax valuations may be performed for taxation planning, compliance, audit support, or litigation purposes.

This discussion focuses on transfer tax and income tax valuations of private companies, business ownership interests in such companies, private company debt and equity securities, and intangible assets. For both transfer tax and income tax purposes, most valuations are intended to conclude the fair market value standard of value.

However, it is noteworthy that taxation-related intercompany transfer price analyses (of tangible property, intangible property, or services) are intended to conclude the arm's-length price standard.

There are generally accepted business valuation approaches and methods. These approaches and methods are applicable to the taxation-related valuation of private companies, business ownership interests in such companies, and private company securities.

Likewise, there are generally accepted intangible asset valuation approaches and methods. These approaches and methods are applicable to the taxation-related valuation of intellectual property, other identifiable intangible assets, and intangible value in the nature of goodwill.

A description of these business valuation and intangible asset valuation approaches and methods is beyond the scope of this discussion.

Of course, analysts who perform such valuations should be familiar with all generally accepted valuation approaches, methods, and procedures. In addition, such analysts should be familiar with the applicable valuation professional standards and the applicable "best practices" valuation professional practices and procedures.

This discussion focuses on the analyst's due diligence procedures in the development of the taxation-related business, security, and intangible asset valuation. The analyst may perform these due diligence procedures at different levels within the subject entity, depending on whether the subject is the private company, a business ownership interest, a security, or an intangible asset.

This discussion focuses on the analyst's performance of due diligence procedures (and primarily the conduct of the subject entity company management interviews) within the context of a transfer tax or income tax valuation.

Analyst Due Diligence Procedures

Whether the valuation subject is the total private company, a controlling or noncontrolling ownership interest in that company, a debt or equity security, or an intangible asset, the analyst will attempt to perform as much due diligence as possible during the development of the valuation.

This due diligence is appropriate whether the valuation is performed for transfer tax, income tax, some other type of tax—or for some other type of purpose. And, this statement is true whether the valuation is performed for tax planning, compliance, audit support, litigation, or some other purpose.

With regard to financial and operational data, this means that the analyst may perform the due diligence procedures at the level of the subject entity that has the most information regarding the subject ownership interest.

One typical procedure in the analyst's due diligence process is the conduct of the subject entity management interviews. The subject entity could be the subject private company, the company that issued the subject debt or equity security, or the company that owns or operates the subject intangible asset.

These management interviews are often referred to generally as due diligence interviews. Typically, the analyst attempts to interview the entity employees who are closest to—and most familiar with—the operations of the subject ownership interest. The following sections recommend practical guidance to the analyst related to the planning for, the conduct of, and the documentation of these due diligence interviews.

The analyst should not necessarily approach these interviews as part of a forensic investigation. That is, the analyst is not trying to "catch" the subject entity management in an untruth or a cover up. Rather, the analyst should approach the due diligence interviews as a fact-finding mission. Therefore, the analyst should apply a healthy degree of skepticism and investigative rigor—to ensure that the analyst receives the complete and unfiltered story regarding the subject entity or the subject ownership interest.

The information obtained by the analyst during the due diligence interview process often affects the development of, the conclusion of, and the reporting of the taxation-related valuation. The analyst's work product may be a value conclusion that is included in a transfer tax or income tax return, a narrative valuation report, an expert report prepared for tax litigation, or expert testimony before either an Internal Revenue Service appeals division hearing officer or a judicial finder of fact.

The due diligence interview process is a procedure performed in virtually every taxation-related valuation. This discussion provides practical guidance to the analyst who is conducting the due diligence interview process—and to the taxpayer or the taxpayer's legal counsel who is relying on the value conclusions. And, this discussion provides the analysis with a checklist of topics to consider during the valuation due diligence investigation.

The Valuation Date Due Diligence Interview Process

There are many ways for an analyst to conduct the due diligence interview for the taxation-related valuation. There is no absolutely "right" way—and no absolutely "wrong" way—for an analyst to conduct the interview. However, there are some practical procedures that may help the analyst to conduct—and to document—an effective due diligence interview of the subject entity management.

First, the analyst should be thoroughly prepared to conduct the interview. The motto "be prepared" is good advice for every aspect of a taxation-related valuation. This "be prepared" advice is especially appropriate during the due diligence interview process.

The analyst's preparation typically includes the performance of these practical procedures:

1. Thoroughly review the subject entity's website and any other publicly available data about the subject entity (or the subject intangible property).

2. Completely review all of the documents that have been provided by the subject entity management, by the taxpayer, and/or by the taxpayer's counsel.
3. Comprehensively review and analyze the subject entity's historical and prospective financial statements. The analyst may pay particular attention to the year-to-year changes in the entity's financial statement account balances.
4. Thoroughly research the subject entity's industry segment and the local, regional, or national economy (as applicable).
5. Actually write out a list of questions to ask each person who will be interviewed during the due diligence interview process.

Second, it is important for the analyst to interview the appropriate individuals. Determining who is (and who is not) an appropriate individual to interview may be a collaborative process, which may involve the participation of the taxpayer or the taxpayer's counsel.

That is, sometimes the taxpayer may know what subject entity employees are most informed about the subject business ownership interest or intangible property. The selection of exactly who is an appropriate individual to interview will vary with each valuation.

Therefore, the analyst may preview the general topics that will be covered during the due diligence interview process with the taxpayer or with the taxpayer's counsel. And, the analyst should request to interview the individuals (at whatever level within the subject entity organization) who are the most knowledgeable regarding the proposed topics.

In some taxation-related valuations, it may be useful for the analyst to interview individuals from outside of the subject entity. Such individuals may include the following:

1. Independent accountants
2. Commercial bankers
3. Principal customers
4. Principal suppliers
5. Principal competitors
6. Former management employees

Of course, many taxpayers (and taxpayer's counsel) may not allow the analyst to interview individuals other than current members of the subject entity management.

The analyst should balance the need for taxpayer confidentiality with the need for information when determining which individuals to interview during the valuation.

Third, the analyst should anticipate an interviewee's potential bias. In a typical taxation-related valuation, the role of the analyst is to conclude the fair market value of the subject business, business ownership interest, security, or intangible asset. Depending on the particular transfer tax or income tax issue, the analyst should be mindful that the taxpayer (or the subject entity management) may prefer either a lower value or a higher value conclusion.

In such a situation—where the taxpayer or the subject entity management may have a bias as to the results of the taxation-related valuation—it is important for the analyst to be:

1. diligent in asking all of the relevant due diligence investigation questions and
2. prepared to ask (and document) follow up due diligence questions.

In most valuations, and especially when the management team has worked for the subject entity for a long time, management has much more information about the entity than the analyst has. This access to (and familiarity with) information gives the management term an advantage in presenting a particular point of view to the analyst.

However, the analyst should endeavor to uncover the complete truth about the issues related to the subject entity by:

1. being sufficiently prepared to conduct the due diligence interviews and
2. being sufficiently prepared to anticipate the potential bias of the taxpayer, the subject entity, management, or other interviewee.

Fourth, if the analyst can control the interview process, the due diligence interview should not be restricted to one session. Let's assume that the analyst follows the practical guidance discussed above—that is, the analyst (1) is prepared, (2) interviews the appropriate individuals, and (3) filters out any potential interviewee bias.

Nonetheless, the initial due diligence interview may uncover unexpected issues about the subject entity or the subject intangible property. These issues may require the analyst to conduct additional research and, consequently, to conduct additional follow-up interviews with the subject entity management.

These follow-up interviews may be needed to allow the analyst to pursue unexpected issues raised during an initial interview. These follow-up interviews may be necessary to help the analyst resolve conflicting "stories" from multiple interviewees. And, these follow-up interviews may be helpful to determine whether the same interviewee changes his or her "story" after a period of time.

New and unexpected issues that are uncovered in the initial interview often turn out to be the important issues in the taxation-related valuation. It is noteworthy that analysts on different sides (i.e., taxpayer and taxing authority) of a valuation often conduct similar analyses and often apply similar methods regarding the subject analysis.

It is often the case that the analyst's treatment of just a few variables will materially affect the value conclusion regarding the subject private company, ownership interest, security, or intangible asset.

Both the analyst's identification of those few variables (and of how those variables may affect the value regarding the subject entity or the subject intangible property) and the analyst's presentation of a persuasive argument for the appropriate treatment of these variables can result in the favorable outcome of a tax audit or tax litigation.

And, the due diligence interview process often helps the analyst to identify which variables are the most important to the taxation-related valuation.

Caveats regarding the Due Diligence Questions

It is important for the analyst (and the taxpayer and the tax counsel, if involved) to recognize several caveats regarding the use of any standardized list of due diligence interview questions.

First, the due diligence questions presented in Exhibit 1 are not intended to be comprehensive or all-inclusive. And second, not every question listed is appropriate for every valuation.

The due diligence questions provided in Exhibit 1 are generally applicable to the valuation regarding the subject private company or intangible property. And, the questions presented in Exhibit 1 are primarily directed to the transfer tax or income tax valuation of a business, business ownership interest, security, or intangible asset.

The questions provided in Exhibit 1 should not substitute for the application of the analyst's independent judgment and professional experience.

Summary and Conclusion

Analysts are often involved in the taxation-related valuation of a private company, business ownership interest, security, or intangible asset. Such valuations may be developed for gift tax, estate tax, generation-skipping transfer tax purposes, or for income tax purposes.

Such valuations may be developed for tax planning compliance, audit support, or litigation support purposes.

In appeal or litigation matters, the analyst may serve the taxpayer—and the taxpayer's legal counsel—as either a consulting expert or a testifying expert.

The due diligence process is one of the generally accepted procedures performed during the taxation-related valuation of a subject entity or subject intangible property.

This discussion presents the foundational elements that the analyst should be aware of with regard to the due diligence component of the taxation-related valuation. In addition, the analyst, the taxpayer, and the taxpayer's legal counsel should be aware of how the due diligence process affects the taxation-related valuation.

With regard to any valuation for transfer tax or income tax purposes, it is important for the analyst to effectively conduct the due diligence interview process. The due diligence interview process is an important valuation procedure.

During the interview process, the analyst often learns important information that may influence the quantitative analyses related to the business, security, or intangible asset valuation.

The primary purpose of the due diligence interview is to enable the analyst to get questions answered. In addition, the interview may also be helpful to uncover information that the analyst may not otherwise have access to.

Representative due diligence interview questions are presented in Exhibit 1. This list is not intended to be comprehensive. Rather, this list is only intended to provide general guidance to the analyst involved in a taxation-related valuation analysis.

The analyst (and the taxpayer and the taxpayer's legal counsel) should recognize that every subject entity and every subject intangible property has unique attributes.

Both the list provided in Exhibit 1—and the practical guidance provided above—should not be considered as substitutes for the analyst's independent judgment and professional experience.

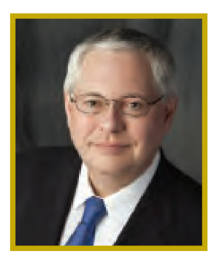


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Exhibit 1
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

For purposes of this exhibit, the due diligence interview questions are divided into four categories:

1. Questions related to the business operations of the subject private entity or the subject intangible property
2. Questions related to the subject industry segment and the subject economy
3. Questions related to the financial statements of the subject private entity or the subject intangible property
4. Questions related to specific events that may affect the subject private entity or the subject intangible property

Even the experienced analyst may fail to ask the perfect question to uncover every material issue related to the subject entity or intangible property valuation. Therefore, at the end of the due diligence interview session, the analyst may ask each interviewee a catch-all question. For example, the analyst may ask, "Do you know of any information that has not been covered and that could have a bearing on the issues we talked about?" This type of general question may provide an opportunity for the interviewee to volunteer any material information that was previously undisclosed.

Questions Related to the Subject Entity or Subject Intangible Property Operations

This category of questions may help the analyst understand how the subject entity or the subject intangible property operates. By asking these questions, the analyst may gain an understanding of the business risks and opportunities that exist for the subject entity or the subject intangible property.

Every taxation-related valuation has unique aspects. These questions may help the analyst to uncover the factors that are unique to the subject entity or subject intangible property valuation.

Subject Entity History and Organization

1. When was the subject entity founded?
2. Describe the key events in the entity's history.
3. Describe any historical business unit mergers, acquisitions, or divestitures.
4. Describe any historical ownership changes.
5. Describe any historical changes in the entity's lines of business.
6. Describe any historical changes in the geographic area served by the subject entity.
7. For a private company, provide a list of the entity owners and their respective ownership interests.
8. Are any of the entity owners currently active in the business? If yes, explain.
9. Is there any entity stock that is subject to any stockholders' agreement, stock transferability restriction agreement, buy-sell agreement, etc.?
10. List the names of any subsidiaries of the subject entity or ownership interests in other companies, including the percentage owned by any parent company.
11. List all known related parties (including subsidiaries, affiliates, or relatives) that the subject entity does business with.
12. List the states (or the countries) in which the subject entity currently transacts business.
13. Describe the locations of the entity's principal facilities and the primary activities that occur at each facility.
14. For a private company, describe all historical transactions in the entity's stock in the five years prior to the valuation date. Describe the circumstances surrounding each of the transactions, including whether the transaction was at arm's-length.
15. Describe all current litigation involving the subject entity or the subject intangible property, with these matters categorized as to (a) claims against the subject entity and (b) claims on behalf of the subject entity.

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

Subject Entity Services (or Products) Offered

1. Describe the subject entity's service/product lines and the approximate percentage of the entity's most recent fiscal year revenue and gross profit produced by each service/product line.
2. Describe the process by which the entity prices its services/products.
3. What other products or services typically compete with the subject entity?
4. What are the advantages and disadvantages of the entity's products or services versus the products or services of the competitor companies?
5. Why do clients/customers select the subject entity to provide products or services—instead of the competitor companies?
6. How long is the typical sale cycle for the entity's products or services?
7. How frequently are the entity's products or services changed/modified?
8. Which of the entity's product or service lines have achieved the fastest revenue growth? Which of the entity's product or service lines have reported the slowest revenue growth?
9. Which product or service lines are the most profitable? And, which product or service lines are the least profitable?
10. Does the subject entity own patents, proprietary technology, or trade secrets that prevents or hinders competitor companies from duplicating its products or services?
11. Describe any products or services that are unique, or not easily duplicated by new or existing competitors.
12. Are the revenue from the entity's products or services cyclical?
13. Are the revenue from the entity's products or services seasonal? If so, what are typically the strongest and weakest months for the entity's revenue?
14. What are the entity's plans for future services/products?
15. Describe the research and development activities of the subject entity.

Subject Entity Manufacturing (or Production)

1. What percentage of the entity's products or services is actually produced by the entity? And what percentage of the entity's products or services is subcontracted to a third party?
2. Where are the subject entity facilities?
3. Describe the subject entity production process for its services or products.
4. Is the entity's process more labor intensive or more capital intensive?
5. What are the ages and the conditions of the subject entity facilities?
6. What is the capacity of each facility relative to the current operating levels?
7. Who is the manager of each facility, and how long has he or she been employed by the entity?
8. Does the entity have any planned expansion of its facilities?
9. Does the entity have any planned asset dispositions related to its facilities?
10. How do the entity's facilities compare to similar companies in the same industry segment?
11. Do the facilities enable the entity to earn superior or inferior profit margins compared to similar companies in the same industry segment? Why?
12. How technologically advanced are the subject entity processes?
13. Are the entity's employees unionized?
14. Describe the entity's relationship with its employees.
15. Does the subject entity have any outstanding workers compensation claims?

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

Subject Entity Clients (or Customers)

1. Provide an overview of the entity's client/customer base.
2. How are the subject entity services used by the clients/customers?
3. List the entity's 10 largest clients or customers (as measured by revenue) for the most recent fiscal years, and the percentage of total revenue made from each of those clients or customers.
4. For the entity's largest recurring clients or customers (as measured by revenue), how long has that party been a client or customer of the subject entity?
5. Does the subject entity provide credit to any of its clients or customers? If so, describe the conditions in which the entity offers credit and the credit terms offered by the entity.
6. Do the entity's clients or customers tend to consistently purchase services from the same company, or do they periodically switch services providers?
7. Identify the most important markets for the subject entity products or services.
8. What are the key recent trends in each of these markets?
9. Are the entity's key markets increasing, decreasing, or stable in terms of size?
10. Does the subject entity have existing contracts with its clients or customers? If so, provide copies of representative contracts.
11. Approximately how many current clients or customers does the subject entity have?
12. Is the subject entity typically the sole supplier of products or services to its clients or customers? Or do clients or customers typically buy products or services from multiple suppliers?
13. Are there any large contracts, significant new clients or customers, or new markets that the entity anticipates adding during the next 12 months?
14. Are there any large contracts, existing clients or customers, or present markets that the subject entity expects to lose, terminate, or abandon during the next 12 months?
15. Does the subject entity provide products or services to federal, state, or local governments or governmental agencies? If so, what percent of the entity's total business is from federal, state, or local governments or governmental agencies?

Subject Entity Suppliers

1. What raw materials or other supplies does the subject entity rely on?
2. Who are the entity's principal suppliers?
3. How many suppliers does the subject entity have?
4. Are any of those suppliers the sole source of supply for the subject entity?
5. For each key supplier, how long has the entity had a business relationship with that supplier?
6. Are any of the suppliers the only (or the primary) company that supplies the entity's industry segment with a particular product?
7. Describe how the entity's principal supplies were/are priced?
8. What has been the trend in the entity's cost of supplies?
9. List—and provide copies of—any long-term supply contracts or other special purchasing arrangements in place with suppliers.
10. How much notice is required by either the subject entity or the supplier to terminate the business relationship?

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

11. Could the subject entity switch suppliers without a detrimental impact on the business? Why or why not?
12. If the subject entity had to find a new supplier for a key supply, (a) could it and (b) how long would it take to find a new supplier?
13. Has the subject entity considered becoming more vertically integrated by acquiring a supplier or by expanding its line of business?
14. To what extent does the subject entity fabricate versus assemble products, and how much flexibility does the entity have in this respect?
15. Does the subject entity use derivatives or other hedging activities to protect against increasing prices?

Subject Entity Sales and Marketing

1. What is the approximate total size of the market (in dollars) for the products or services offered by the subject entity?
2. What is the entity's estimated market share for each of the products or services offered?
3. How has the entity's market share for each of its product or service lines changed in the last five years? Ten years?
4. What are the most important selling features of the entity's products or services (i.e., price, quality, brand name, service, etc.)?
5. What warranty does the subject entity offer for its products or services? And, how frequently do customers or clients submit warranty claims?
6. How intense is the competition in the entity's industry segment?
7. How are the entity's products or services priced?
8. Describe how new business opportunities are identified, followed-up, prioritized and pursued, and by whom.
9. What distribution channels does the subject entity use for its products or services?
10. How is technology used in the entity's marketing?
11. Describe any changes in the entity's marketing budget from year-to-year.
12. Describe the typical level of experience and typical tenure of the entity's sales staff.
13. Does the subject entity depend on one employee or on a small number of employees to generate sales?
14. Describe the historical turnover rate of the entity's sales staff.
15. On what basis are the subject entity salespeople compensated?

Subject Entity Management and Other Employees

1. Provide a copy of the entity's most current organization chart, along with resumes for the senior members of the entity's management team.
2. How long have the senior members of the entity's management team been employed by the entity?
3. Do any of the senior members of the entity's management team have known health issues? And, are any of the senior members of the management team close to retirement age?
4. Provide the total compensation for each member of the entity's management team, including perquisites.
5. How many hours per week do each of the senior members of the entity's management team spend working for the entity?
6. How many employees does the subject entity have?
7. What unions (if any) represent the entity's employees, and when do any union contracts expire?
8. How many of the entity's employees are covered by collective bargaining agreements?

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

9. Has the subject entity ever experienced any work stoppages due to a strike?
10. What is the total number of employees in each organizational area?
11. What are the critical skills and backgrounds needed in the development, production, and distribution of the entity's products/services?
12. Identify any management or technical positions that have been difficult for the subject entity to fill due to shortages of labor with the appropriate skills.
13. Describe the current labor market for the entity's industry segment. That is, is the supply of employee candidates robust or sparse?
14. How extensively does the subject entity use independent contractors?
15. List the members of the subject entity board of directors and provide a description of the background of each member.

Subject Entity Outlook

1. Describe the subject entity's strengths, weaknesses, opportunities, and threats.
2. What are the most important things the subject entity must accomplish to be successful over the next five years?
3. What is the entity's expected annual growth rate over next five years in terms of revenue, operating profit, and net profit?
4. What is the biggest risk to the subject entity achieving its projected financial results of operations?
5. What could cause the subject entity actual financial results of operations to exceed—or fall short of—the projected financial results of operations?
6. What is the level of capital spending required to support the entity's projected revenue growth?
7. What are the known large and infrequent capital expenditures that will be made by the subject entity within the next five years (e.g., a plant expansion, an IT upgrade, or the replacement of major equipment)?
8. Do you expect any changes in the product or service lines offered by the subject entity in the next five years (due to either expansion or contraction)?
9. Are there any internal factors that may constrain the entity's business growth, such as lack of access to capital or insufficient cash?
10. Does the subject entity plan to acquire other companies in the next five years?
11. Are the entity's profit margins expected to change over the next five years? Why or why not?
12. Does the subject entity prepare an annual budget? Does the subject entity prepare a long-term financial plan, projection, or forecast? Describe the process that is applied to create the entity's annual budget. Describe the process that is applied to prepare the entity's long-term financial plan, projection, or forecast.
13. Is the entity's annual budget or forecast considered to be conservative, baseline, or aggressive?
14. How do the entity's projected revenue growth and profit margins compare to the entity's historical revenue growth and profit margins?
15. Does the subject entity plan any changes in ownership in the future (for example, through either share buybacks or the issuance of shares)?

Questions Related to the Subject Entity's Industry Segment and Economic Factors

These questions may help the analyst to put the subject entity in context relative to other similarly situated companies. In addition, these questions may also help the analyst to better understand the long-term outlook for the subject entity or the subject intangible property.

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

Industry and Economy

1. What national or regional economic factors affect the entity's revenue growth (e.g., interest rates, inflation rate, disposable income, etc.)?
2. How does the subject entity differ from other competitor companies in the relevant industry segment?
3. How has the subject entity performed during recent economic downturns? During recent strong economic periods?
4. Is government regulation a factor for the subject entity? If so, how?
5. What stage of the industry life cycle is the entity's industry segment in (i.e., introduction, growth, maturity, or decline)?
6. What are the most important recent developments or trends in the entity's industry segment?
7. How many companies of the entity's approximate size (e.g., revenue within plus or minus 50 percent) operate in the industry segment?
8. Is the industry segment generally comprised of small local companies or large multinational companies?
9. Describe the barriers to entry in the entity's industry segment.
10. How has the size of the industry segment changed in the last five years?
11. How is the size of the industry segment expected to change in the next five years?
12. What level of innovation and/or change is required to stay competitive in the entity's industry segment?
13. Does the subject entity generally lead or lag the industry segment in terms of new services, pricing, and other similar factors?
14. Is the technology employed at the subject entity considered (a) outdated, (b) current, or (c) leading edge compared to the industry segment standard?
15. What trade associations do the subject entity belong to?

Competition

1. Who are the most significant competitors to the subject entity? Describe any publicly traded competitors—as well as any privately owned competitors.
2. Does the subject entity management monitor the financial results and/or public filings of any publicly traded peer group companies? Describe which ones.
3. How large are the entity's principal competitors in terms of revenue?
4. Where are the entity's principal competitors located?
5. What are the principal competitors' estimated market shares for each of the products or services offered by the subject entity?
6. What are the primary strengths and weaknesses of the principal competitors—in comparison to the strengths and weaknesses of the subject entity?
7. On what basis do companies in the entity's industry segment compete (e.g., brand, price, quality, service, technology, or some other basis)?
8. How often do the entity's clients or customers switch between the subject entity and its competitors?
9. How easy is it for the entity's clients or customers to switch between the subject entity and its competitors?
10. Do any principal competitors have proprietary technology, trade secrets, patents, copyrights, trademarks, or other intangible property that give them a competitive advantage over the subject entity?
11. Do the entity's principal competitors have greater or weaker economies of scale compared to the subject entity?

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

12. How has competition changed in the last five years (i.e., new competitors, regulatory changes that affected competition, erosion of pricing power, etc.)?
13. How does branding help (or hurt) the subject entity to compete? Or, are the entity's services/products unbranded and considered to be commodity services/products by the entity's clients or customers?
14. For each product or service line, if the subject entity bids on a business opportunity, (a) what competitor companies does it typically compete against and (b) why is/isn't the subject entity typically successful in winning the competitive bid?
15. How intense is the competition among the companies in the entity's industry segment?

Questions Related to the Subject Entity Financial Statements

Understanding the entity's (or the intangible property's) financial statements is an important procedure in just about any business or intangible asset valuation. This is because of the significant impact that the financial statements may have on the subject entity value or the subject intangible property value.

A discussion of the entity's historical financial statements may also inform the analyst as to any financial statement normalization adjustments—or financial statement errors or irregularities—that need to be considered in the business or intangible asset valuation.

The analyst should develop a general understanding of each account on the subject entity's financial statements. And, the analyst should develop a more thorough understanding of the more material accounts on the subject entity's financial statements.

Consider, for example, the entity's accounts receivable account. The analyst may want to investigate:

1. if the subject entity management considers the stated accounts receivable account balance to be collectable,
2. how long the accounts receivable typically remain outstanding,
3. what client/customer accounts are included in the accounts receivable account balance,
4. if the accounts receivable balance is related to the subject entity revenue or to some other business activities, and/or
5. other similar issues.

Questions that relate to each and every account balance on the subject entity financial statements are not included in the list below. This is because the number of such questions that relate to each individual account on the financial statements would be beyond the scope of this discussion.

Subject Entity Historical Financial Results

1. If applicable, provide a copy of the independent accountant's letters to the subject entity management (or directors) for the past five years.
2. Describe the accounting principles used by the subject entity (e.g., revenue recognition methods, cash versus accrual basis, and property accounting methods).
3. Have there been any changes in the accounting principles applied in the preparation of the entity's financial statements over the past five years?
4. How do the current accounting principles compare to the accounting principles used by other competitor companies in the entity's industry segment?
5. Explain all significant year-over-year changes in the financial statement accounts (e.g., the interviewee may explain changes such as (a) a 50 percent annual increase in accounts payable, (b) a 15 percent annual decrease in revenue, or (c) the gross margin improved from 30 percent of sales to 40 percent of sales).

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

6. Describe any nonrecurring or extraordinary income or expense items recorded during the past five years.
7. What plan does the subject entity have for capital expenditures during the next 12 months?
8. Has the subject entity management or the board of directors received any bona fide offers to buy the entity during the past five years? If so, describe the details of each offer or provide a copy of any written offers received.
9. Have any of the stockholders personally guaranteed the entity's loans? If yes, explain.
10. Describe any short-term and long-term sources of credit and how they were used by the subject entity over the past five years.
11. Is the entity's current capital structure (a) sustainable and (b) expected to change over the next five years?
12. Has the subject entity complied with all of its outstanding loan covenants? If not, explain why.
13. Discuss the entity's dividend history and the outlook for future dividend payments.
14. Summarize any assets owned by the subject entity that may be classified as (a) nonoperating assets or (b) excess assets. That is, are there any assets that do not contribute to the primary operations of the subject entity (e.g., cash and cash equivalent balances that may not be needed for future working capital or capital expenditures)?
15. Describe all of the entity's intangible assets and of the entity's contingent liabilities that are not recorded on the entity's balance sheet.

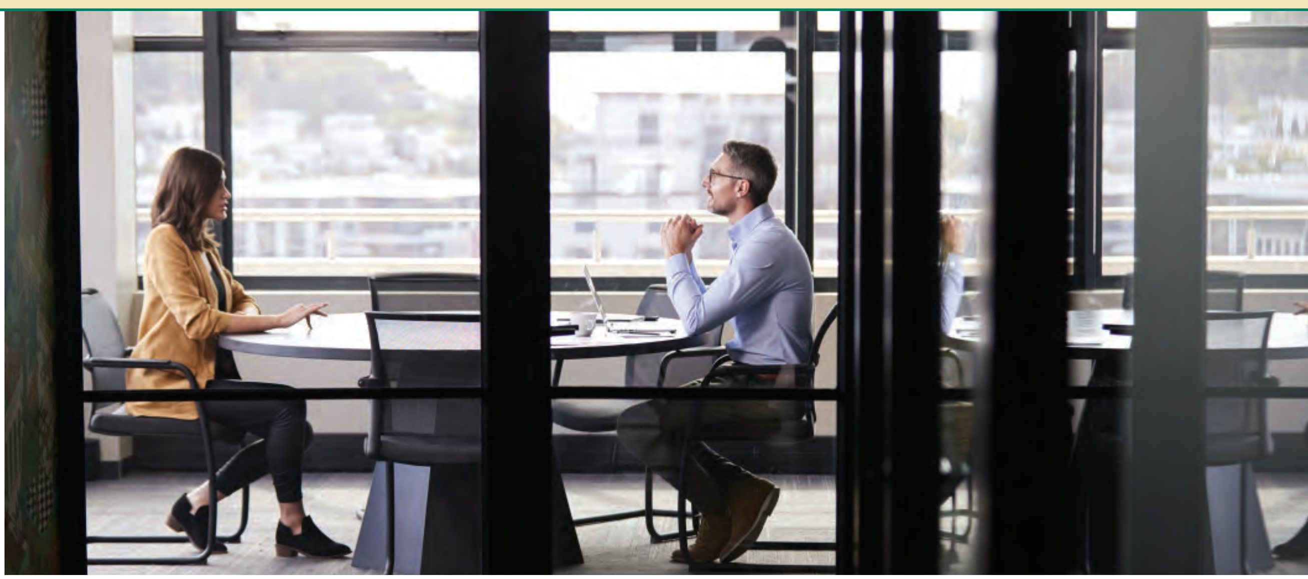
Questions Related to Specific Events That May Impact the Subject Entity or Intangible Property

These questions may help the analyst to identify the most significant events that affected the subject entity or the subject intangible property in recent years. These questions may also help identify the significant events that could affect the subject entity or the subject intangible property in the near future.

1. Does the subject entity operate with any license, permit, franchise, or other agreement that permits the entity to operate—either at the total entity level or at the intangible property level? Which of these licenses, etc., are private party agreements? Which of these licenses, etc., are government-issued agreements?
2. How important is location to the entity's results of operations? Could the subject entity move its facilities and still maintain its planned results of operations? What type of impact would a facility relocation have on the entity's planned results of operations?
3. What type of intellectual property does the subject entity own or operate. Specifically, what patents, copyrights, trademarks, and trade secrets does the subject entity own or operate?
4. What procedures does the subject entity employ to protect its intellectual property?
5. What would be the expected impact if the subject entity lost the right to (or ability to) operate its intellectual property?
6. Does the subject entity either inbound license or outbound license any of its intellectual property? If so, please provide copies of all such licenses.
7. What are the most significant long-term contractual agreements that the subject entity has entered into? For example, consider these types of long-term agreements: supplier agreements, customer/client agreements, executive employment agreements, noncompetition agreements, joint development agreements, joint venture agreements, etc. Please provide copies of each of those agreements. Have any such agreements even been unexpectedly terminated or violated? If so, please describe the impacts of that unexpected agreement termination or violation.

Exhibit 1 (cont.)
Transfer Tax and Income Tax Valuations
Related to a Private Company, Business Ownership Interest, Security, or Intangible Asset
Representative Due Diligence Interview Questions

8. How important are the entity's banking relationships? How stable are the entity's banking relationships? How frequently does the subject entity change its banking relationships?
9. What are the entity's principal sources of debt capital? What are the agreements (i.e., notes and debt indenture agreements, bond indenture agreements, long-term leases) that document those financing arrangements? Has the subject entity ever violated the terms of any of these financing arrangements? If so, what were the consequences of such violations?
10. In the last five years, has the subject entity participated in any mergers, service line or entity acquisitions, service line liquidations, or service line divestitures? Please describe each such transaction. Please describe the impact on the subject entity of each such transaction.
11. In the last five years, has the entity implemented a restructuring of its long-term debt or a recapitalization or reorganization of its capital structure? Please describe each such transaction. Please describe the impact on the subject entity of each such transaction.
12. Does the subject entity maintain confidentiality agreements, nondisclosure agreements, nonsolicitation agreements, or any similar agreements with any of its employees? If so, which employees—and how were these employees—selected? Please provide copies of those agreements. Has the entity ever had to enforce these agreements? If so, how?
13. In the last five years, was the subject entity involved in an income taxation, a property taxation, or other taxation audit or dispute at any level? Has the subject entity been involved in a regulatory agency audit or dispute at any level? Has the entity been involved in an environmental audit or dispute at any level? If so, how was each of these audits or disputes resolved? What was the impact of each of these audits or disputes?
14. During the last 10 years, was the subject entity involved in any litigation (as either plaintiff or defendant) involving competitors, merger or acquisition parties, contract counterparties, financial institutions, government agencies, or similar parties? If so, please describe the claims of each litigation matter. Please describe the resolution of each litigation matter.
15. During the last 10 years, was the subject entity involved in any litigation (as either plaintiff or defendant) involving any member of the entity management, any entity director, or any current or former shareholder? If so, please describe the claims of each litigation matter. Please describe the resolution of each litigation matter.



Analyst Considerations in Applying a Discount for Lack of Control in Transfer Tax Valuations

Nathan P. Novak and Robert F. Reilly, CPA

Valuation analysts ("analysts") often have to consider the issue of "level of value" in private company business and security valuations performed for either gift tax, estate tax, or generation-skipping transfer tax (collectively "transfer tax") purposes or income tax purposes. The level of value issue relates to the considerations of (1) marketability (or the lack of marketability) and (2) ownership control (or the lack of ownership control) related to the subject business ownership interest. These considerations are often incorporated into the private company valuation through the analyst's application of valuation adjustments. These valuation adjustments may be either valuation discounts (or value reductions) or valuation premiums (or value increases). This discussion focuses on analyst considerations with regard to applying a discount for lack of control in the valuation of a private company performed for either transfer tax or income tax purposes.

Introduction

Valuation analysts ("analysts") are often retained to value private companies, private company ownership interests, and private company securities for tax purposes. These tax purposes could involve gift tax, estate tax, and generation-skipping transfer tax (collectively referred to herein as "transfer tax").

Such transfer tax valuations could be performed for purposes of tax planning, tax compliance (including tax return preparation), Internal Revenue Service ("Service") audit support, and tax litigation (including testifying expert services).

To develop the transfer-tax-related valuation, the analyst has to understand the subject ownership interest, of course. That is, the analyst has to know if the valuation subject is the entire private company (whether a corporation, partnership, limited liability company, etc.), a particular ownership interest in the company (e.g., a 50 percent ownership interest), or a particular security in the company (e.g., 1,000 shares of Class B nonvoting common stock).

The analyst has to know the legal ownership interest subject to valuation. That is, the analyst should be instructed as to whether the valuation subject should be valued in fee simple interest—or as a term interest, a reversionary interest, or some other limited bundle of legal rights.

In addition, the analyst should be informed as to whether the valuation subject is encumbered by a shareholders' agreement, or buy/sell agreement, or any other contractual provisions that would restrict transferability or would otherwise affect the security value.

Of course, the analyst has to be instructed as to the appropriate valuation date (typically the date of ownership transfer, for transfer tax purposes). The analyst has to be instructed as to the appropriate standard (or definition) of value. For transfer tax purposes, the appropriate standard of value is typically fair market value.

The analyst has to be informed as to the appropriate premise of value. For transfer tax purposes, the typical premise of value regarding a private business ownership interest is value in continued use—or value on a going-concern basis.

However, the analyst should also consider the highest and best use ("HABU") of the private company operating assets. It is at least possible that the HABU of the subject private company would be reflected by the valuation premise of value in exchange—as an orderly disposition of the company's assets.

Levels of Value

Finally, the analyst should consider the appropriate level of value. The concept of level of value is sometimes overlooked by the taxpayer or the tax planner—or even the tax counsel. However, the concept of level of value is not overlooked by the Service or other taxing authorities, and it should not be overlooked by the analyst.

In the transfer tax valuation of a business, business ownership interest, or security, the level of value encompasses two primary considerations:

1. The marketability of the subject ownership interest
2. The ownership control attributes of the subject ownership interest

As a simplified introduction, the marketability consideration involves how easy it is for the owner to sell the subject interest ownership and convert it into immediate cash proceeds. The ownership control consideration involves how much influence the subject ownership interest has over the operations of the subject private company.

As will be discussed below, the ownership attributes of marketability and control are not absolute considerations. Rather, they are each represented by a continuum. That is, ownership interests are typically not perfectly marketable nor are they perfectly nonmarketable. Rather, they typically exist somewhere along a continuum of marketability.

Likewise, ownership interests typically do not represent absolute control or absolute noncontrol of the private company. Rather, ownership interests typically exist somewhere along a continuum of control rights and privileges.

The issue of level of control directly affects the transfer tax valuation when the analyst has to adjust a value indication concluded on one (i.e., the unintended) level of value in order to conclude another (i.e., the intended) level of value.

For example, the valuation analyst may conclude the value of a private company ownership interest on a marketable basis—but the appropriate level of value is a nonmarketable basis. In such an instance, the analyst has to account for that difference in ownership attributes—and in value.

Likewise, the valuation analyst may conclude the value of a private company ownership interest on a controlling basis—but the appropriate level of value is a noncontrolling basis. In such an instance, the analyst has to account for that difference in ownership attributes—and in value.

To account for these differences in ownership attributes, the analyst will apply "valuation adjustments." These valuation adjustments can involve the application of either valuation premiums (i.e., incremental value adjustments) or valuation discounts (i.e., decremental value adjustments). The reason for the analyst applying a valuation adjustment is to get from "what you have" to "what you want."

In the above paragraph, "what you have" is a value indication that was developed to indicate a level of value different from the level of value that is appropriate to the transfer tax valuation assignment. "What you want" is the level of value that corresponds to the actual subject ownership interest in the transfer tax valuation assignment.

As discussed below, the requirement for such a valuation adjustment is created by the fact that some generally accepted business valuation approaches and methods typically conclude one level of value. That concluded level of value may not be the level of value that is appropriate for the transfer tax valuation assignment.

For example, the application of the market approach guideline publicly traded company ("GPTC") method typically concludes a marketable ownership interest level of value. However, if the valuation subject is actually a nonmarketable business interest, then the analyst may apply a discount for lack of marketability ("DLOM").

This DLOM valuation adjustment "adjusts" the GPTC method value indication to make it more applicable to, say, the nonmarketable stock of a private company. That is, the analyst applied the valuation adjustment in order to get from "what you have" (i.e., a marketable security value indication) to "what you want" (i.e., a nonmarketable security value indication).

Some generally accepted business valuation approaches and methods typically conclude a controlling ownership interest level of value. For example, the application of the market approach guideline merged and acquired company ("GMAC") method typically concludes a controlling ownership interest level of value. However, if the subject of the transfer tax valuation is a noncontrolling ownership interest, then the analyst may have to apply a discount for lack of control ("DLOC") valuation adjustment in order to conclude a meaningful value conclusion.

The analyst's consideration related to the application of a DLOC in a transfer tax valuation is the subject of this discussion.

The difference in the price that a willing buyer would pay for a controlling ownership interest compared to an otherwise comparable noncontrolling ownership interest may represent a material value adjustment. This price difference is often referred to as the DLOC.

The DLOC measures the difference between:

1. the price that a willing buyer would pay for a private company controlling business ownership interest and
2. the price that a willing buyer would pay for an otherwise identical private company noncontrolling business ownership interest.

This discussion summarizes (1) the concept of ownership control in a transfer tax valuation, (2) the reasons why analysts apply a valuation adjustment (i.e., a price discount or a price premium) in a private company business valuation, (3) the theoretical models and the empirical studies that analysts typically consider in order to measure the amount of any DLOC, and (4) the factors that may influence the magnitude of the DLOC in any particular transfer tax valuation.

The Concept of Ownership Control

By definition, the owner of a noncontrolling ownership interest in a private company:

1. lacks many of the so-called perquisites of ownership and
2. has little or no control over the private company's operating, investing, and financing activities.

A willing buyer contemplating the purchase of a noncontrolling business ownership interest from a willing seller would consider the economic disadvantages associated with that lack of ownership control. As a result, a noncontrolling business ownership interest in a private company is often worth less, on a pro rata or per-ownership-interest basis, than a controlling business ownership interest in the same private company.

The value of ownership control derives from the business owner's ability to influence the private company by exercising what are often called the prerogatives of control.

The following nonexhaustive list indicates some of the typical prerogatives of ownership control with regard to the operation of a private company:

1. Ability to select the management of the company
2. Ability to determine management compensation (including bonuses) and other employment perquisites
3. Ability to set operational and strategic policy and change the course of the company's business operations
4. Ability to acquire and/or liquidate some—or all—of the company's assets
5. Ability to select suppliers, vendors, and subcontractors with whom the company will do business (including self-selection)
6. Ability to borrow funds, repay long-term debt, or otherwise enter into financing transactions on the behalf of the entity
7. Ability to liquidate, dissolve, sell, or recapitalize the company—or to enter into a merger transaction
8. Ability to declare and pay dividends or other distributions—or to decide not to pay such distributions
9. Ability to change the company's articles of incorporation, partnership or limited liability company agreement, or bylaws
10. Ability to enter into leases, licenses, or other contracts (including entering into self-dealing contracts)

However, these so-called prerogatives of ownership control, which are typically associated with a private company controlling ownership interest, possess little value in and of themselves. Instead, the value of owning a controlling ownership interest in a private company is derived from the controlling owner's ability to exercise those prerogatives of ownership control so as to generate economic benefits that would be greater than the economic benefits generated under the company's current stewardship.[1]

Therefore, a rational investor would not be willing to pay a price premium for a controlling ownership interest unless the change of control transaction would allow that investor to exercise some—or all—of the prerogatives of ownership control in order to achieve incremental economic benefits.[2]

In general, such economic benefits can be accomplished by (1) increasing the available cash flow—either the company's total cash flow generation or the amount of cash flow available to the controlling owner and/or (2) decreasing the investor's required rate of return on investment in the subject company (i.e., by decreasing the risk of the business interest investment to the controlling owner).

If the subject private company is already being managed with a high degree of effectiveness and efficiency, then, potentially, the investor may not be able to increase the company's total cash flow generation. In such an instance, there may be relatively little incremental value that would result from a change-in-control transaction.

In such a case, most—or all—of the incremental value associated with the ownership control position would result from the investor (i.e., the controlling owner) redirecting economic benefits away from the noncontrolling owners (or from other company stakeholders)—and to the controlling owner.

It is up to the analyst to consider whether or not a change of control transaction could result in (1) increased cash flow (either to the private company overall—or redirected cash flow to the control owner) and/or (2) decreased required rate of return on investment for the subject ownership interest (either decreased risk due to the private company overall—or decreased risk solely due to the control owner).

And, if the analyst considers that a change of control transaction could result in increased economic benefits (either to the private company overall—or solely to the controlling owner), then it is up to the analyst to identify the specific factors that would support that conclusion.

Another factor that the analyst would consider when deciding whether or not to apply a DLOC in the analysis is the business valuation approach and method that was applied to reach the value conclusion. In other words, the analyst should consider what level of value was concluded from each valuation method's value indication before considering the application of a DLOC.

For example, as discussed below, the application of the income approach discounted cash flow ("DCF") method may conclude a value indication that represents either a noncontrolling ownership interest level of value or a controlling ownership interest level of value. The DCF method level of value indication depends on the components of the financial projections and on the components of the present value discount rate that are applied in that valuation method.

In instances in which the valuation method is applied to already conclude a noncontrolling ownership interest level of value, it may be unnecessary for the analyst to apply a DLOC. This is because the DCF method resulting value indication is already concluded from the perspective of a noncontrolling investor.

Alternatively, the application of the market approach GMAC method (often also called the guideline transaction method) typically concludes a value indication on a controlling ownership interest level of value basis. In that instance, it may be appropriate for the analyst to apply a DLOC to the value indication derived by the GMAC method. The application of the DLOC would then adjust the GMAC method value indication so as to conclude a noncontrolling ownership interest level of value.

The analyst's decision to apply a DLOC in the transfer tax valuation of a private operating company is typically a three-step process.

The first step in this process is for the analyst to determine whether the valuation method applied in the analysis develops a value indication that concludes (1) a controlling ownership interest level of value or (2) a noncontrolling ownership interest level of value.

Depending both (1) on the level of value of the valuation subject ownership interest and (2) on the purpose and objective of the business valuation, further adjustments and analysis may not be needed after making that determination.

That is, the analyst has to conclude whether the selected valuation method already develops a value indication on a noncontrolling ownership interest basis. If so, it may not be necessary for the analyst to adjust the value indication by applying a DLOC.

The second step in the process is for the analyst to determine whether a change in control transaction could result in incremental economic benefits to a controlling owner. If so, that analyst determination may indicate that there is a material difference between:

1. the fair market value of a noncontrolling ownership interest and

2. the fair market value of a controlling ownership interest.

The third step in the process is for the analyst to determine the magnitude of any incremental economic benefits available to the control owner—in order to estimate the amount of any applicable DLOC.

Reasons to Apply a Valuation Adjustment

All other valuation variables assumed to be equal, the investment risk of a noncontrolling ownership interest is typically greater than the investment risk of a controlling ownership interest in the same private company.

The greater investment risk stems from (1) the noncontrolling interest holder's inability to exercise the prerogatives of ownership control and (2) the potential for the controlling interest holder to make decisions (and to implement procedures) that are detrimental to the noncontrolling ownership interest holder.

Accordingly, the difference in value between a noncontrolling ownership interest and a controlling ownership interest may be representative of this difference in investment risk.

As described above, the magnitude of the difference in investment risk—and its overall impact on the subject interest's fair market value—can vary greatly depending on the specific factors related to:

1. the subject ownership interest and
2. the subject private company.

Theoretical Methods to Quantify the DLOC

Application of the Discounted Cash Flow Model

The DCF business valuation method is based on the principle that the value of a private company—or an ownership interest/security in such a company—equals the present value of future income expected to be generated by that company or ownership interest. Consequently, all other valuation variables assumed to be equal, if future company/security income increases, then the fair market value of the company/security increases.

As discussed earlier, a controlling ownership interest may be valued at a price premium to an identical noncontrolling ownership interest if the controlling interest holder is able to enhance his or her economic benefits by exercising all—or some—of the prerogatives of ownership control.

This increase in economic benefits to the control owner can be accomplished by:

1. increasing the company's total cash flow or the control owner's specific cash flow and/or
2. decreasing the company's—or the control owner's—required rate of return on investment.

With respect to a DLOC, the analyst may apply a functional analysis to determine whether a change of control transaction could (1) enhance the company's or the control owner's cash flow or (2) decrease the company's or the control owner's required rate of return on investment.

To make this determination, the analyst may (1) develop a DCF valuation analysis by applying financial projections from a noncontrolling ownership interest perspective, (2) develop a DCF valuation analysis by applying financial projections from a controlling ownership interest perspective, and (3) compare the two value indications provided by the two DCF valuation analyses.

This comparison should help the analyst to determine the value adjustment (i.e., price discount) attributable to a lack of ownership control (or, alternatively, the price premium attributed to ownership control).

It is noteworthy that, if the analyst is able to estimate a value conclusion for both (1) a noncontrolling level of value DCF valuation analysis and (2) a controlling level of value DCF valuation analysis, then the resulting value conclusions likely do not need to be further adjusted for ownership control attributes.

That is, if the transfer tax valuation objective is to estimate the fair market value on a noncontrolling ownership interest basis, and if the DCF valuation analysis develops a noncontrolling ownership interest level of value, then it is not necessary to apply an additional DLOC to that value indication.

However, the analyst may compare the two value indications developed by the two DCF valuation analyses in order to estimate an applicable DLOC percentage to apply to controlling ownership interest value indications developed by the other generally accepted business valuation approaches and methods.

Factors to Consider in the Application of the Discounted Cash Flow Model

As previously discussed, the analyst may perform some type of functional analysis to determine the extent to which a change of control transaction may result in an opportunity to enhance the control owner's economic benefits.

The following list provides some of the ways that the cash flow (i.e., either the total company's cash flow or the control owner's cash flow) may be increased through a change of control transaction:

1. Increased revenue growth
2. Increased operating profit margins
3. Working capital efficiencies
4. Capital expenditure efficiencies

It is noteworthy that many of the above-listed economic benefits may not be achievable simply through a change of control transaction. Often, the achievement of these economic benefits is contingent on the new controlling owner:

1. having access to alternative markets,
2. commercializing alternative production and supply channels, or
3. exploiting post-control event synergies or economies of scale.

In those instances, it may be important for the analyst to distinguish between:

1. the economic benefits that would be attributable to synergies that a specific new control owner may be able to achieve and
2. the economic benefits that any typical (or hypothetical) new controlling owner may be able to achieve.

It is possible that a change of control transaction may not either increase the private company revenue or decrease the private company operating expenses or capital costs. If the subject private company is already operated efficiently, there may be few opportunities to generate incremental cash flow. This means that the ownership control price premium or, conversely, the DLOC may be relatively small—at least at the total company level.

Nonetheless, the new control owner may still be willing to pay a control price premium. This control price premium would result from the control owner being able to divert economic benefits away from the noncontrolling owners—or from other company stakeholders.

The value of a controlling ownership interest may also be increased due to a decreased required rate of return on investment resulting from a change of control transaction. Such a decrease in the required return on investment would be associated with a decrease in the investment risk to the new control owner.

The following list provides some of the ways that a decrease in the required rate of return on investment may be achieved through a change of control transaction:

1. Optimized company capital structure
2. Greater access of the company to capital
3. Diversification of the company's operating risk

As is the case for a post-transaction increased net cash flow, the ability to influence the required rate of return on investment may be unobtainable simply through a change of control transaction. For example, if the private company's capital structure is already at an optimal level, then there may be little opportunity to decrease the required rate of return on investment by altering the company's capital structure.

Again, the control owner could still reduce his or her investment risk—and reduce his or her required return on investment—by diverting risk to the noncontrolling owners—or to other company stakeholders.

The analyst may perform a functional analysis to determine whether a change of control transaction could result in increased net cash flow (to the company or to the control owner) or decreased investment risk (to the company or to the control owner).

The analyst should consider the possibility of achieving the results listed above, as well as other company-specific factors discussed below, when considering the application of a DLOC.

Company-Specific Factors

The analyst should also consider company-specific factors when evaluating the prospect of enhancing economic benefits under a change of control transaction.

Analysts often consider the following nonexhaustive list of company-specific factors when considering whether or not the application of a DLOC is appropriate to the transfer tax valuation:

1. The current stage of the private company's life cycle

2. The quality of the private company management
3. The level of the company management compensation
4. The company's capital structure
5. The current management's goals and objectives
6. The regulatory risk factors in the private company's industry
7. Guidance provided by the company's corporate governing documents

After considering the aforementioned factors and how they apply to the circumstances surrounding the subject ownership interest, the analyst may determine whether the application of a DLOC is appropriate to the transfer tax valuation.

Empirical Studies to Quantify the DLOC

The analyst may determine that a DLOC is applicable based on:

1. the business valuation approaches and methods applied and
2. the company-specific factors described above.

Based on that judgmental determination, the analyst may rely on empirical studies to help quantify the amount of the DLOC.

Generally, empirical studies apply analyses that are based on empirical capital market transaction observations—rather than on theoretical economic principles. Empirical studies typically rely on actual transactional data to provide evidence for estimating a DLOC.

There are two types of empirical data that analysts may consider to help quantify the DLOC for a noncontrolling ownership interest in a private company:

1. Studies of the stock price premiums offered (over the pre-tender-offer market price) in the acquisition of publicly traded companies (i.e., going-private acquisition price premium data)
2. Analyses of share price variations from the net asset value of publicly traded closed-end mutual funds (i.e., closed-end mutual fund pricing data)

Public Company Acquisition Price Premium Data

One source of data that analysts sometimes consider in measuring a DLOC is the study of public company "going-private" acquisition tender offers. By considering public company stock acquisition price premiums offered during a change of control transaction, the analyst may obtain some empirical guidance as to the pro rata value difference between a controlling ownership interest and a noncontrolling ownership interest.

Acquisition tender offer price premiums vary widely, with the median tender offer tender offer price premium typically ranging from approximately 25 percent to approximately 40 percent over the average public market price in the months just prior to the offer announcement. The high end of the range of public company stock tender offers includes acquisition price premium of over 100 percent and the low end of the range includes acquisition price discounts.

Both ends of the range indicate that there may be special factors involved. It is noteworthy that an acquisition price premium of 25 percent to 40 percent is equivalent to a pre-acquisition price discount of approximately 20 percent to 29 percent.[3]

That is, the acquisition price premiums reported in the acquisition tender offer empirical studies often include consideration paid for the acquirer for expected synergistic value. All things considered, the presence of expected synergistic value would result in relatively larger acquisition price premiums.

Accordingly, acquisition price premium data are often considered to represent the high end or the maximum amount of a reasonable control price premium—or the corresponding DLOC. Alternatively, the analyst may attempt to disaggregate the total acquisition price premium into its two components:

1. Ownership control price premiums
2. Synergistic price premiums

The analyst may apply judgement in order to remove the impact of consideration for synergistic price premiums from the indicated total acquisition price premiums.

In order to do so, the analyst often attempts to distinguish—or allocate—between (1) the portion of the total acquisition price premium that relates to a control price premium only and (2) the portion of the total acquisition price premium that relates to a synergistic price premium.

Some procedures that the analyst may consider in order to make such adjustments to the tender offer acquisition price premium data include:

1. focusing on acquisitive transactions that include financial buyers only, so as to limit the amount of any synergistic price premiums that would presumably be paid in such transactions and
2. focusing on the lower end of the range of indicated acquisition price premium data (e.g., the first quartile of the acquisition price premium data in the measurement of the acquisition price premium).

As a generalized rule of thumb, analysts sometimes look at acquisition price premium data and assign half of the total acquisition price premium to the control price premium and the other half of the total price premium to the synergistic price premium. Analysts sometimes apply this total acquisition price premium allocation procedure as a default procedure. That is, the analyst may apply this simplistic 50 percent/50 percent allocation assumption if there is no other factual basis for performing the total price premium allocation.

Ideally, the analyst would be able to rely on industry-specific or target-company-specific data in order to perform a more supportable total acquisition price premium allocation.

To illustrate the application of this default rule of thumb allocation procedure, let's consider the following simplified example. Let's assume the analyst has selected the appropriate public company acquisition price premium data.

These data would relate to the going-private acquisitions of publicly traded companies in an appropriate Standard Industrial Classification ("SIC") code or industry group. These data would relate to the acquisition of public companies of a size that would provide meaningful pricing guidance to the analyst. And, these public company going-private acquisitions were completed during a time period that would be relevant to the subject valuation date.

Let's assume the analyst considered these acquisition price premium data and concluded that a representative total price premium for the acquired public companies was 40 percent. The analyst understands that only some of that 40 percent total price premium (i.e., the acquisition price paid in excess of the pre-tender-offer publicly traded stock price for the target companies) relates to the transfer of ownership control.

The other reason why the acquirer paid a purchase price premium is the acquirer's expectation of post-merger synergies (unrelated to the transfer of ownership control).

In the absence of any additional industry-specific or acquisition-specific information, the analyst may allocate half of the representative 40 percent total price premium—or 20 percent—to the transfer of ownership control. In other words, the analyst assumed that the control price premium component of the total price premium was 20 percent.

This assumed control price premium still has to be converted into a DLOC. As mentioned above, the DLOC is calculated as the mathematical reciprocal of the control price premium. That is, the DLOC = 1 – [1 ÷ (1 + control premium %)].

In this simplified example, the analyst's assumed 20 percent control price premium would indicate a DLOC of approximately 17 percent. And, again, the 20 percent control price premium is based on the analyst's simplified assumption regarding the allocation of the total acquisition price premium indication.

Closed-End Mutual Fund Pricing Data

Analysts also extract noncontrolling ownership interest DLOC measurement guidance from the analysis of publicly traded closed-end mutual fund pricing data. By observing the difference between the closed-end mutual fund share price and the closed-end mutual fund per-share net asset value, a price discount/price premium to net asset value may be calculated.

In a publicly traded closed-end mutual fund, a shareholder is unable to exercise control over the fund's investment portfolio. Similarly, in a private company, typically a noncontrolling shareholder is unable to exercise the prerogatives of ownership control to influence the operation of the private company.

Analysts often consider the research regarding the reasons why many closed-end mutual funds typically trade at a price discount to net asset value.

Some of the following reasons have been suggested by that research:

1. Poor operating performance of the mutual fund
2. Weak management of the mutual fund
3. Poor prospects for the mutual fund
4. High expense ratios within the mutual fund
5. Low cost basis assets within the fund
6. Lack of diversification of the fund's investment portfolio

As intuitive as some of the above-listed factors may appear, there remains little empirical evidence that conclusively explains why closed-end mutual funds typically trade at a stock market price discount compared to their per-share net asset value.

It is noteworthy that ownership interests in publicly traded closed-end funds are similar to a noncontrolling ownership interest in a private company in many respects. A noncontrolling private company owner is:

1. in no position to influence the private company management and
2. dependent on the decisions made by the controlling owner.

Likewise, for a noncontrolling owner of a closed-end fund, a closed-end fund shareholder is:

1. not in a position to influence the management of the mutual fund portfolio and
2. dependent on decisions made by the mutual fund manager.

This lack of control over the assets of the private company or the mutual fund provides a reasonable explanation why a DLOC may be applicable to the valuation (1) of the private company business interest or (2) of the closed-end mutual fund shares.

It is generally accepted that the observed closed-end fund price discount data provides guidance with respect to a DLOC (and not to a discount for lack of marketability). That is, shares of publicly traded closed-end funds trade on an organized stock market exchange. Therefore, shares of the publicly traded closed-end funds are as liquid as most fully marketable equity securities.

Valuation Example

A simplified example may illustrate the impact of the DLOC on the transfer tax valuation. Let's assume that Thomas D. Taxpayer owned 25 percent of the limited liability company ("LLC") membership units of Private Construction Company, LLC ("Private LLC").

Let's assume that Tom Taxpayer passed away on September 30, 2020. Accordingly, his private company business ownership interest is included in his estate.

Let's assume that tax counsel for the estate retains the analyst to estimate the fair market value of Tom's ownership interest for estate tax return preparation purposes. The analyst starts the transfer tax valuation assignment by valuing all of the Private LLC owner's equity.

The analyst applied the generally accepted business valuation approaches and methods.

The analyst developed an income approach and DCF method value indication (by considering the total cash flow expected to be generated by the construction company operations).

The analyst developed a market approach and GMAC method value indication (by analyzing recent sale transactions of comparable construction companies).

And, the analyst developed an asset-based approach and asset accumulation method value indication (by estimating the current market value of all of the company's tangible assets and intangible assets).

Based on a synthesis of the value indications provided by these three generally accepted business valuation approaches, the analyst concluded that the fair market value of 100 percent of the Private LLC owners' equity was $100 million, as of September 30, 2020.

Tom passed away owning 25 percent of the company's LLC units. Therefore, the fair market value of the ownership interest in Tom's estate appears to be $25 million.

The $100 million fair market value conclusion may be appropriate for the Private LLC entire business. But, let's say there were four equal partners (technically, members) who owned Private LLC. If all four members (including the executor of Tom's estate) decided to sell Private, LLC, they would expect to receive $100 million in total sale price consideration for the entire company.

However, this transaction represents the transfer of a marketable, controlling ownership interest in the company. Collectively, all four members can decide to sell Private LLC—and thereby make it marketable. Collectively, all four members would transfer control of the total company to the new owner (say, a corporate acquirer).

Therefore, the $100 million transaction price represents the value of a marketable, controlling ownership interest in Private, LLC.

However, Tom's estate does not own a marketable, controlling ownership interest. Rather, Tom's estate owns a nonmarketable, noncontrolling ownership interest in Private, LLC. Unlike the market for the entire construction company, there is no market for Tom's block of LLC units in Private LLC.

In fact, those units may be subject to the contractual transferability restrictions included in the company's membership agreement. In addition, Tom's block of LLC units would provide the new owner with little or no control over the operations of Private, LLC.

At this stage in the transfer tax valuation, the analyst will apply a DLOM and a DLOC to the pro rata Private, LLC, business value in order to conclude the fair market value of the estate's ownership interest. Let's assume the analyst selects a 30 percent DLOM. (A description of DLOM measurement procedures is beyond the scope of this discussion.)

Then, the analyst considered control price premium indications extracted from sale price data related to public construction company going-private acquisitions. In addition, the analyst considered pricing data related to publicly traded mutual fund stock price to net asset value discounts.

Finally, the analyst considered the actual management structures, the corporate governance practices, and the equity ownership allocation of Private, LLC.

Based on all of the above-listed factors, let's assume that the analyst selected a 20 percent DLOC as appropriate to the estate's ownership interest in the Private, LLC, units.

Based on the above set of hypothetical facts and circumstances, the analyst would conclude the fair market value of the estate's ownership interest as presented in Exhibit 1.

In other words, the Tom Taxpayer estate would not report the $25 million ownership interest value for transfer tax purposes. Rather, based on the analyst's fair market value valuation of the subject LLC units (including consideration of the appropriate DLOC), the Tom Taxpayer estate would report the $14 million ownership interest value for transfer tax purposes.

Summary and Conclusion

Valuation analysts are often called on to estimate the fair market value of business ownership interests for transfer tax purposes. These business ownership interests may include private companies,

Exhibit 1
Estate of Thomas D. Taxpayer
Ownership Interest in Private Construction Company, LLC
Fair Market Value
As of September 30, 2020

Transfer Tax Valuation Analysis	(in millions)
Fair Market Value of the Private, LLC, Total Equity	$100.0
Multiplied by: Tom Taxpayer Estate LLC Units Percentage Ownership	25%
Fair Market Value Indication of the Estate Ownership Interest—on a Marketable, Controlling Ownership Interest Basis	$25.0
Less: 30% Discount for Lack of Marketability	7.5
Equals: Subtotal	$17.5
Less: 20% Discount for Lack of Control	3.5
Equals: Fair Market Value of the Tom Taxpayer Estate LLC Units—on a Nonmarketable, Noncontrolling Ownership Interest Basis	$14.0

ownership interests in such companies, and the debt and equity securities of such companies.

The transfer tax at issue may be a gift tax, estate tax, or generation-skipping transfer tax. And, such valuations may be performed for tax planning, compliance, audit support, or litigation purposes.

One of the factors that the analyst considers in the transfer tax valuation of the private company business interest is the level of value. The business ownership interest's level of value is primarily described by two elements:

1. Marketability
2. Control

That is, the analyst will assess where the subject business interest falls in the continuum ranging from (1) perfectly marketability to (2) perfectly nonmarketable.

In addition, the analyst will assess where the subject business interest falls in the continuum ranging from (1) total ownership control to (2) a total lack of ownership control.

Some of the generally accepted business valuation approaches and methods typically conclude a value indication on a controlling ownership interest level of value. When the analyst applies such a business valuation method, a controlling ownership interest level of value indication is "what you have." If the subject of the transfer tax valuation is a noncontrolling business ownership interest, a noncontrolling ownership interest level of value indication is "what you want."

In order to get from "what you have" (a controlling interest level of value indication) to "what you want" (a noncontrolling interest level of value conclusion), the analyst typically has to quantify—and apply—a DLOC.

This discussion summarized the factors that the analyst typically considers in the application of a DLOC in a transfer tax valuation.

In estimating the DLOC, an analyst should consider all of the facts and circumstances relevant to the subject business ownership interest. Based on the facts of the specific valuation analysis, there are times when certain factors are more relevant than others.

Based on consideration of the factors mentioned above, the analyst may determine that a change of control transaction may result in:

1. increased cash flow to the private company or to the control owner and/or
2. a decreased required rate of return on investment for the private company or to the control owner.

In such an instance, there may be a difference between:

1. the value of a noncontrolling ownership interest in the private company and
2. the value of a comparable controlling ownership interest in the private company.

However, the application of a DLOC is only appropriate if the business valuation method applied by the analyst developed a value indication on a controlling ownership interest level of value basis. If the business valuation method applied by the analyst already developed a value indication on a noncontrolling ownership interest level of value basis, then it would be unnecessary to quantify and apply a DLOC.

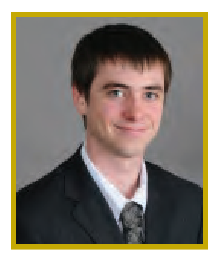
If the analyst concluded that there is little or no incremental value that can be derived from a change of control transaction—particularly to the control owner—that conclusion may indicate that there is little difference between:

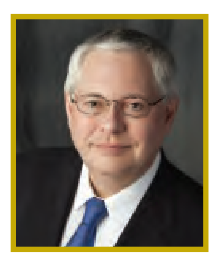
1. the controlling ownership interest level of value for the subject business interest and
2. the noncontrolling ownership interest level of value for the subject business interest.

In such an instance, it may be appropriate for the analyst to apply a minimal (or no) DLOC in the transfer tax valuation of the subject business ownership interest.

Notes:

1. VFR Valuation Advisory #3: The Measurement and Application of Market Participant Acquisition Premiums, 9.
2. Ibid.
3. Price discount calculated as 1 – [1/(1 + price premium)]





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GUIDE TO PROPERTY TAX VALUATION

Robert F. Reilly and Robert P. Schweihs

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- 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

Best Practices Discussion

Performing a Functional Analysis as Part of a Valuation, Damages, or Transfer Price Analysis

Robert P. Schweihs and Robert F. Reilly, CPA

A functional analysis can be performed with regard to any business, business ownership interest, security, or intangible asset. For any such type of business or property ownership interest, the functional analysis allows the analyst to identify (and document) (1) the functions performed, (2) the assets employed, and (3) the risks assumed. Many observers immediately associate a functional analysis with an intercompany transfer price analysis related to either tangible property or intangible property. Such transfer price analyses are often (although not always) developed for federal income tax purposes. However, as described in this discussion, a functional analysis is also relevant as part of a damages measurement analysis. And, the development of a functional analysis is also a best practices procedure with regard to a business or property valuation performed for either transfer tax purposes or income tax purposes. This discussion summarizes what an analyst needs to know about performing a functional analysis as one part of a valuation, damages, or transfer price analysis.

Introduction

A functional analysis helps explain to the audience of the work product (that is, the attorney, the taxing authority, the board of directors, the fiduciary, or other reader) the factors the analyst considered when examining the subject property.

A functional analysis is often applied for purposes of assessing the comparability of the subject property to guideline or benchmark properties. These guideline or benchmark properties could be comparable companies, securities, or other properties (such as tangible property and intangible property).

Many observers immediately think of a functional analysis within the context of the allocation of income and deductions among taxpayers for federal income tax purposes.

A functional analysis is one component of a transfer price analysis related to the intercompany transfer of tangible property, intangible property, or services.

An intercompany transfer is a transfer between entities that are under common control. Such entities are often referred to as related parties or associated parties. A typical example of entities that are under common control would be two wholly owned subsidiaries of the same multinational parent corporation.

A functional analysis is certainly relevant to an intercompany transfer price determination made for purposes of Section 482 compliance.

In addition to transfer price analysis, a functional analysis is also relevant within the context of a value estimation and a damages measurement.

For purposes of this discussion, a value estimate includes valuations of privately owned companies, closely held securities, tangible assets, and intangible assets. Such valuations could be developed for transaction, financing, taxation, accounting, litigation, or other purposes.

For purposes of this discussion, a damages measurement includes the quantification of damages related to business entities, business ownership interests, tangible assets, and intangible assets. Such a damages measurement could relate to an injured party's damages sustained with regard to a tort claim or a breach of contract claim.

Such valuation, damages, and transfer price analyses are often performed by valuation analysts, forensic accountants, economists, and other types of professionals. This discussion refers to all of these professionals collectively as "analysts."

This discussion summarizes the application of a functional analysis in the development of a valuation, damages, or transfer price analysis. This discussion considers the following topics:

1. What is (and what is not) a functional analysis
2. The reasons for the analyst to perform a functional analysis within the context of a valuation, damages, or transfer price analysis
3. The functional analysis impact on valuation estimates
4. The functional analysis impact on damages measurements
5. The functional analysis impact on transfer price determinations
6. The 12 steps of a functional analysis
7. Who should perform the functional analysis
8. Documentation of the functional analysis

This discussion summarizes the analyst's basic considerations of the functional analysis within the context of developing a valuation, damages, or transfer price opinion.

What Is Functional Analysis?

As mentioned above, many observers initially think of a functional analysis within the context of an intercompany transfer price determination between the controlled entities of a taxpayer (often a multinational taxpayer) for Section 482 compliance purposes.

While there are broader applications of a functional analysis, the Section 482 regulations provide a definition of a functional analysis that is generally applicable for this discussion.

Regulation 1.482-1(d)(3)(i) relates to comparability issues related to the allocation of income and deductions among taxpayers. Specifically, this regulations section deals with the factors for determining comparability of transactions and companies.

Regulation 1.482-1(d)(3)(i) describes a functional analysis as follows:

> (i) Functional analysis. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include –
>
> (A) Research and development;
>
> (B) Product design and engineering;
>
> (C) Manufacturing, production, and process engineering;
>
> (D) Product fabrication, extraction, and assembly;
>
> (E) Purchasing and materials management;
>
> (F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;
>
> (G) Transportation and warehousing; and
>
> (H) Managerial, legal, accounting and finance, credit and collection, training and personal management services.

While this regulation lists eight functions, it does not imply that the eight-item list is exhaustive. Rather, the regulation section indicates that the factors to consider "include" the eight listed functions. In addition, the regulation does not imply that the listed factors cannot be disaggregated or rearranged.

Basically, for the subject entity, a functional analysis considers the following:

1. The products and services that are offered to customers or clients (and how those products and services are designed or developed)
2. The source of supply of the materials, labor, and overhead that is needed to produce those products and services (including sourcing dependence and sourcing logistics issues)
3. How the products and services are manufactured or otherwise produced
4. How the products and services are differentiated, promoted, priced, and sold (including advertising and branding issues)
5. How the inventory of products and services (including raw materials, work in process, and finished goods/services) are created, packaged, and stored
6. How the products and services are delivered (including shipping, transportation, and other delivery logistics issues)
7. The assets that are utilized to perform the functions within the business entity (including working capital assets, tangible assets, and intangible assets)
8. How profits are earned in the business enterprise (including the cost/volume/profit relationships with regard to both (a) production/service creation cost of sales and (b) production/service delivery revenue recognition)
9. How the accounting, finance, human resources, management information, marketing, sales, and other administrative activities operate within the subject entity
10. How the subject entity is organized, managed, and capitalized (legally and administratively), including both (a) the relationship between the entity owners and the entity operators/managers and (b) the relationship between the entity and its sources of capital

There are various financial, competitive, and operational analyses that may be components of the functional analysis. There are also some types of financial, economic, and industry analysis that are not really components of the functional analysis. These considerations of what are components—and what are not components—of the functional analysis are summarized next.

Considerations That Are Components of the Functional Analysis

Exhibit 1 which begins on page 48 presents a listing of the typical analyst considerations in the performance of a functional analysis.

This Exhibit 1 list is not intended to disagree with or to replace the eight factors listed in Regulation 1.482-1(d)(3)(i). Rather, the Exhibit 1 list is intended to expand on and to clarify the Regulation 1.482-1(d)(3)(i) recommendations.

Exhibit 1 may serve as a list of functional analysis considerations for the analyst when developing a valuation, damages, or transfer price opinion.

Depending on the type of analysis being developed by the analyst, the Exhibit 1 considerations may be used to develop an understanding of the subject entity, ownership interest, or property. The Exhibit 1 considerations may also be used to compare the functions performed, assets employed, and risks assumed between two controlled entities under common ownership.

Also, the Exhibit 1 considerations may be used to compare the functions performed, assets employed, and risks assumed between a controlled transaction and an uncontrolled transaction—particularly within the context of an intercompany transfer price determination.

Considerations That Are Not Substitutes for a Functional Analysis

The following analyses may also be performed as part of a valuation, damages, or transfer price analysis. And, the following analyses may be considered as a part of—or a component of—a functional analysis.

However, the following analyses are not a substitute for a functional analysis of the subject entity, ownership interest, or tangible/intangible property:

1. Historical financial statement ratio or trendline analysis
2. State of the regional or national economy analysis
3. State of the subject industry (or the subject profession) analysis
4. Acquisition due diligence analysis
5. Quality of earnings analysis
6. SWOT analysis
7. History and description of the subject entity, ownership interest, or property
8. Selection (and analysis) of guideline public companies or guideline merger and acquisition transactions or guideline royalty rates

Each of the above analyses have a place in a business or property valuation, damages, or transfer price analysis. However, each of the above analyses is different than a functional analysis of the subject entity, ownership interest, or property.

Reasons to Perform a Functional Analysis

Whether the analyst's assignment is a value estimate, damages measurement, or transfer price determination, the reasons for conducting a functional analysis are pretty much the same.

The first reason to conduct a functional analysis is to familiarize the analyst with the subject entity, ownership interest, or tangible/intangible property. The research required and the diligence necessary to conduct the functional analysis results in the analyst developing both a broad and a deep understanding of the subject of the analysis.

By performing the functional analysis, the analyst better understands how the subject works.

The second reason to conduct a functional analysis is to allow the analyst to assess comparability. The comparability assessment may allow the analyst to accomplish the following:

1. Identify and select comparable companies, comparable transactions, comparable licenses, or other comparable transfers
2. Compare and contrast the functions of two related party (or associated) entities that are under common ownership (i.e., two controlled parties)
3. Compare and contrast a controlled transaction with one or more uncontrolled (i.e., arm's-length) transactions
4. Make normalization adjustments to comparable companies, transactions, and licenses to make them more comparable to the analysis subject
5. Make comparisons of the conditions in transactions between related parties—that is, the controlled transactions—with the conditions in comparable transactions between unrelated (or arm's-length) parties—that is, the uncontrolled transactions

The third reason to conduct a functional analysis is to allow the analyst to assess the relative contribution of the various functions performed either (1) within the subject entity or (2) between the related (or associated) parties in a controlled transaction.

The fourth reason to conduct a functional analysis is to allow the analyst to identify the various assets that are used:

1. in the operation of the subject entity or
2. in the conduct of the controlled transaction.

These assets are employed to perform the various functions associated with the subject entity. The assets considered in the functional analysis may include working capital accounts, tangible assets (real estate and tangible personal property), and intangible assets.

The fifth reason to conduct a functional analysis is to allow the analyst to identify the risks that are being assumed by the subject entity. A significant portion of the return earned by the entity's operations is due to the risks assumed by the entity. The functional analysis allows the analyst to compare these risks:

1. within the subject entity;
2. between the subject entity and the selected comparable companies, transactions, and licenses; and
3. between related party (or associated) entities in a controlled transaction.

Each of these five reasons will assist the analyst in the development of the valuation, the damages measurement, or the transfer price determination.

Functional Analysis Impact on the Valuation Estimate

The functional analysis allows the analyst to understand the source of value creation within the subject entity. While the functional analysis is primarily considered a procedure for assessing—and adjusting for—comparability, the functional analysis does not only affect the market approach to business or property valuation. There are comparability considerations in all generally accepted valuation approaches.

The three generally accepted approaches to value a business or business ownership interest are the income approach, the market approach, and the asset-based approach.

The three generally accepted approaches to value a tangible property or an intangible property are the income approach, the market approach, and the cost approach.

In the income approach, the functional analysis informs the analyst with regard to:

1. revenue projections,
2. expense projections,
3. investment projections,
4. present value discount rate components, and
5. expected long-term growth rate considerations.

In the market approach, the functional analysis informs the analyst with regard to:

1. normalizing the historical financial or operational results of the subject entity or property;
2. selecting comparable (or guideline or benchmark) companies, transactions, or licenses;
3. adjusting/normalizing the historical financial or operational results of the comparable companies, transactions, or licenses;
4. selecting the adjusted pricing multiples that were extracted from the comparable companies, transactions, or licenses; and
5. applying the selected market-derived pricing multiples to the subject entity, ownership interest, or property.

In the asset-based approach, the functional analysis informs the analyst with regard to:

1. the valuation of tangible assets,
2. the existence of identifiable intangible assets,
3. the applicable valuation variables (including useful economic life) to apply to the identifiable intangible assets,
4. the capitalized excess earnings method valuation of goodwill, and
5. the valuation of liabilities—and, particularly, contingent liabilities.

In the cost approach, the functional analysis informs the analyst with regard to:

1. the valuation the measurement of useful economic life—for both tangible property and intangible property;
2. the identification and measurement of functional obsolescence (including the technological obsolescence component) of tangible property;
3. the identification and measurement of economic obsolescence of tangible property;
4. the normalization of the property owner's financial and operational metrics—particularly with regard to intangible property; and
5. the selection of the valuation variables to perform the capitalized income loss method to measure economic obsolescence for intangible property.

As indicated above, the functional analysis has applications to all of the generally accepted business valuation approaches and property valuation approaches.

Functional Analysis Impact on Damages Measurement

Analysts are often asked to identify and measure damages related to businesses, business ownership interests, tangible property, or intangible property. These damages are often caused by an alleged wrongful action.

The alleged wrongful action that is the cause of the damages could relate to:

1. a breach of some type of contractual agreement or
2. a tortious action.

The contract could include any type of acquisition contract, commercial goods or services contract, license, lease, franchise, employment or services agreement, noncompete/nonsolicitation agreement, or other commercial contract. The tort could include a breach of fiduciary duty, lender liability duty, duty to shareholders, or any other type of duty.

In the measurement of the business or property damages, analysts often consider these generally accepted damages measurement methods:

1. Lost profits
2. Reasonable royalty rate
3. Cost to cure (including lost business or property value)

The functional analysis informs the analyst throughout the damages measurement assignment. First, the functional analysis helps the analyst identify the component of the business or property that was damaged.

The functional analysis may not identify the damages event or the party who committed the alleged wrongful action. Rather, the functional analysis should help to identify the following:

1. What entity/property functions were damaged
2. The relative importance of those damaged functions to the subject entity/property

3. The value creation due to the functions—or, in this case, the value destruction due to any damage to those functions.

Second, the functional analysis should help to identify the entity/property's normal financial or operational variables—that is, the entity/property's metrics "before" or "without" the damages event. The analyst can compare those normal financial or operational variables to the entity/property's current metrics—that is, "after" or "with" the damages event. The differences in these metrics before and after (or without and with) damages is one measure of lost profits.

In particular, the functional analysis may help the analyst to develop (and test the reasonableness of) any damages projection variables—including revenue, expenses (fixed and variable), investments, and other prospective financial variables.

Third, the functional analysis may help the analyst to identify:

1. when the damages impact started (i.e., the beginning of the damages period),
2. the term of the damages period, and
3. when the damages impact ended—if it did end (i.e., the end of the damages period).

Fourth, the functional analysis may help the analyst to identify and measure the impact of any mitigation efforts in response to the damages event.

Fifth, the functional analysis may help the analyst to identify, compare, normalize, select, and apply arm's-length license agreement royalty rates in a reasonable royalty rate damages analysis.

Sixth, the functional analysis may help the analyst to identify the costs to cure the impact of the damages event. This is because such an analysis may identify the particular entity/property functions that were damaged—to allow the analyst to estimate the cost to cure (i.e., repair) the damaged function.

Seventh, the functional analysis may inform the analyst's selection of the historical valuation variables to develop the "before" business or property valuation. The current (post-damages event) application of the functional analysis may inform the analyst's selection of the post-damages valuation variables to develop the "after" business or property valuation. The difference in the "before" value and the "after" value is one indication of the lost business value or property value.

The development of the functional analysis may also help the analyst to identify all of the entity's operational components and tangible/intangible assets that were affected by the damages event.

In addition, the performance of the functional analysis may help the analyst to quantify the lost profits, reasonable royalty rate, or cost to cure related to the business or property damages.

Functional Analysis Impact on Transfer Price Determination

As mentioned above, a functional analysis is an important procedure in an intercompany transfer price analysis. The transfer price analysis helps to identify the value chain. A value chain separates a business into a series of value-generating functions.

This value chain helps provide the analyst with a foundation from which to identify:

1. the functions performed,
2. the assets employed, and
3. the risks assumed.

This foundation helps the analyst to understand the activities that create value in the subject entity, ownership interest, or property.

As mentioned above, Regulation 1.482-1 provides an introduction to the allocation of income and deductions among taxpayers. Regulation 1.482-1(d)(3)(i) describes a functional analysis within the context of the factors for determining the comparability of transactions.

Regulation 1.482-2 includes guidance related to the determination of taxable income in specific situations. These specific situations include:

1. loans or advances,
2. the performance of services for another,
3. the use of tangible property, and
4. the transfer of property.

Regulation 1.482-3 describes the methods to determine taxable income with a transfer of tangible property. These methods for determining an arm's-length transfer price with regard to tangible property include:

1. the comparable uncontrolled price method,
2. the resale price method,
3. the cost plus method, and
4. unspecified method.

Regulation 1.482-3(c)(3)(ii)(A) discusses functional comparability with regard to the resale price method. Specifically, this regulation section deals with comparability and reliability considerations within the application of the resale price method.

Regulation 1.482-3(d)(3)(ii)(A) discusses functional comparability with regard to the cost plus method. Specifically, this regulation section deals with comparability and reliability consideration within the application of the cost plus method.

Regulation 1.482-4 describes the methods to determine taxable income with regard to the transfer of intangible property. First, this regulation provides a description of what is intangible property. Second, this regulation describes the following methods for determining an arm's-length transfer price with regard to intangible property:

1. Comparable uncontrolled transaction method
2. Unspecified methods

Regulation 1.482-5 describes the comparable profits method. Specifically, regulation 1.482-5(c)(2)(ii) discusses functional, risk, and resources comparability. This regulation section presents these factors within the context of comparability and reliability considerations in the application of the comparable profits method.

Regulation 1.482-6 describes the application of the profit split method. This regulation provides guidance with regard to:

1. the comparable profit split method and
2. the residual profit split method.

Regulation 1.482-7 relates to cost sharing arrangements. Regulation 1.482-8 provides examples of the application of the best method rule.

Regulation 1.482-9 relates to the determination of an arm's-length transfer price related to controlled services transactions. Regulation 1.482-9(d)(3)(kk)(A) describes functional comparability. This regulation section discusses comparability and reliability considerations within the context of the application of the gross services margin method.

Regulation 1.482-9(c)(3)(ii)(A) also describes functional comparability. This regulation section discusses comparability and reliability considerations within the context of the application of the cost of services plus method.

In all cases, the regulations discuss the functional analysis within the context of assessing—and adjusting for—comparability. These assessments—and adjustments—are made:

1. to the subject entity or property or
2. between the related (or associated) parties to the controlled transaction.

These assessments and adjustments are based on:

1. the relative contribution of the various functions performed,
2. the assets (both tangible and intangible) used to perform these functions, and
3. the risks assumed by the subject entity or the related parties.

The 12 Steps of the Functional Analysis

As mentioned above, there are many considerations related to the development of a functional analysis. These many considerations are equally relevant whether the functional analysis is developed for valuation, damages, or transfer price purposes. And, to reiterate, Exhibit 1 was intended to only present a partial listing of typical analyst considerations.

Exhibit 1 does not present a comprehensive list of all analyst considerations. However, all of the analyst considerations or procedures may be categorized into what this discussion refers to as the 12 steps of the functional analysis.

These 12 steps do not necessarily have to be performed in the order or sequence presented below. However, the following listing of steps is presented in a logical sequence and may be performed simultaneously. This discussion recommends that all of the 12 steps should be developed, to a greater or less extent, before the functional analysis is completed.

It is important to recognize that each so-called "step" represents a category or grouping of many analyst procedures and investigations. These categories of procedures are called "steps" to remind the analyst to proceed from the initial understanding of the subject entity to the final assessment of the risks assumed by that subject entity.

After completing all of these 12 steps, the analyst should have developed—and documented—an understanding of the subject entity's functions performed, assets employed, and risks assumed.

These 12 steps—or categories or groupings of analyst procedures—are listed in Exhibit 2 on page 52.

The first 10 steps on Exhibit 2 primarily relate to the functions performed at the subject entity. Step 11 on Exhibit 2 primarily relates to the assets employed at the subject entity. And, step 12 on Exhibit 2 primarily relates to the risks assumed by the subject entity.

For purposes of this discussion and for purposes of applying Exhibit 2, the phrase the "subject entity" encompasses an individual subject entity, an ownership interest in such an entity, the tangible property or intangible property of such an entity, or two related parties performing associated functions (and controlled transactions) as part of a common ownership entity.

The Type of Analyst to Conduct the Functional Analysis

There is no specific guidance or limitation as to what type of professional should perform the functional analysis. Similarly, there is no specific guidance or limitation as to what type of professional should perform a valuation analysis, damages measurement, or transfer price determination.

Some observers have referred to the functional analysis as an economic analysis. It is true that the functional analysis includes the consideration of the inputs and the outputs of a subject entity. Similarly, the functional analysis includes the consideration of the cost/volume/profit relationships of a subject entity.

And, these considerations involve the application of microeconomics principles. But, by that general definition, all valuation, damages, and transfer price analyses involve the application of microeconomics principles.

The *Internal Revenue Manual* doesn't address the question of what type of professional should perform the functional analysis. However, the *Internal Revenue Manual* does provide perspective on the various types of professionals who may be involved in the transfer price analysis related to intangible property.

Section 4.61.3.4.6 of the *Internal Revenue Manual* relates to "Transfers of Intangible Property," and it provides the following perspective related to intangible property comparable uncontrolled transactions and arm's-length license royalty rate analyses:

> 7. Determining arm's length royalty amounts for controlled transfers of intangibles may require the support of the following specialists:
>
> a. Economists
>
> b. Engineers
>
> c. Industry experts
>
> d. Experts in the field of licensing intangibles
>
> e. Marketing experts
>
> f. Other inside and outside experts

The fact that economists are mentioned first in the above listing may be one reason why some observers associate economists with intercompany transfer price analyses. While the above list specifically relates to intangible property transfer prices, it is reasonable to conclude that any of the above-mentioned categories of professionals could perform a functional analysis.

In addition to the *Internal Revenue Manual* listing of types of professionals, accountants—and particularly forensic accountants—have particular experience and expertise with regard to all three disciplines of valuation, damages measurement, and transfer price determination. All three of these disciplines require a thorough understanding of generally accepted accounting principles ("GAAP"), income tax accounting principles, accounting systems and procedures, and the analysis of financial statements and other financial documents.

In addition, most forensic accountants have a breadth and depth of experience related to business operations, data gathering and special investigations, and due diligence procedures and associated documentation.

Although not specifically mentioned in the *Internal Revenue Manual*, valuation analysts have unique training and experience that would qualify them to perform the functional analysis.

Valuation analysts routinely apply microeconomics principles. Valuation analysts have to understand both GAAP accounting and income tax accounting. And, most valuation analysts are skilled at data gathering, interviewing and investigative techniques, and due diligence procedures.

Most importantly, valuation analysts have to develop both broad and deep skills with regard to performing, interpreting, and applying comparability analyses.

That is, most valuation analysts are experienced with regard to identifying, adjusting, normalizing, extracting pricing data from, and applying pricing multiples derived from comparables. And, such comparables could include comparable companies, comparable business interests, comparable tangible property, and comparable intangible property. And, the comparable transactions could include sales, leases, licenses, or other types of transfers.

Valuation analysts have experience and expertise in assessing and adjusting for comparability—a fundamental component of the functional analysis. In addition, like certified public accountants, valuation analysts pursue specialized training based on a standardized body of knowledge, are tested and credentialed based on that standardized body of knowledge, must pursue continuing professional education requirements, and comply with documented ethics standards and other professional standards.

Many of the other types of professionals included in the above *Internal Revenue Manual* list do not meet these various qualifications.

Overall, and more important than a particular professional credential or academic benchmark, the appropriate type of professional to perform the functional analysis is a professional who understands how that functional analysis can be applied in the development of the value estimate, the damages measurement, or the transfer price determination.

Documentation of the Functional Analysis

As with the type of professional who performs the functional analysis, there is no specific guidance or requirement related to the documentation of the functional analysis. The following recommendations are presented as best practices (and not as professional standards or professional organization requirements) related to functional analysis within the context of a valuation or a damages measure or a transfer price analysis.

This best practices guidance assumes that the analyst prepares some type of written or oral report to document the development and the conclusion of the subject analysis.

As a general best practice, both the analyst's work papers and the analyst's report (for valuation or damages or transfer price) should include documentation of the following:

1. The selection of—and the rejection of—all relevant considerations and steps—and the reasons for that selection and/or rejection
2. The data gathering process applied with regard to all of the selected considerations
3. The selection of (and the rejection of—and the reasons therefor) all data sources
4. A listing of all documents generally considered and of all documents specifically relied on in the functional analysis, including a description of the source of each document (copies of all of the documents relied on by the analyst should be included in the work paper file)
5. All due diligence procedures performed (including the conduct of any subject entity management interviews or any third-party interviews)
6. Schedules and exhibits prepared to summarize all of the quantitative comparability and other analyses performed
7. The analyst's assessment of each consideration developed—documented with a commentary, description, flowchart, or other explanation
8. The analyst's conclusion related to each of the 12 steps (or the 12 categories of procedures)—documented with a commentary, description, flowchart, or other explanation
9. A listing of each of the qualitative or quantitative factors leading up to the analyst's conclusions regarding these functional analysis components:
    a. Functions performed by the entity—and the relative importance thereof
    b. Assets employed by the entity—both tangible and intangible assets
    c. Risks assumed with regard to the subject entity's operations
10. A narrative summary and conclusion describing the analyst's functional analysis opinion, including a conclusory discussion of (a) functions performed, (b) assets employed, and (c) risks assumed

Also as a general best practice, analysts may become familiar with the analysis documentation and reporting procedures describe in the following publications:

1. *The Mandatory Performance Framework*
2. *The Application of the Mandatory Performance Framework*

These best practices documentation guidelines were developed for the Certified in Entity and Intangibles Valuation ("CEIV") professional credential program developed by the Corporate and Intangibles Valuation Organization, LLC. These best practices guidelines are only "mandatory" for CEIV credential holders when they are performing fair value measurement valuations.

However, while not mandatory for non-CEIV analysts, these guidelines do provide "best practices" guidance with regard to the analysis documentation and reporting. Such best practices guidance with regard to the functional analysis may also be applied generally to all aspects of the valuation, damages, or transfer price analysis.

There are various lists available with regard to the performance of a functional analysis—particularly within the context of an intercompany transfer price determination. For example, the *Internal Revenue Manual* includes a "Transfer Pricing Functional Analysis Questionnaire" as Exhibit 4.61.3-4 of that manual.

The use of such a list is a convenient resource for the analyst, particularly for purposes of completing a functional analysis with regard to Section 482 compliance.

However, any list or questionnaire only documents what the analyst should do—that is, the procedures the analyst should perform. While such a listing of procedures to perform is an important component of the functional analysis documentation, it does not provide a complete set of the functional analysis documentation.

The work papers and the report should not only describe the procedures that the analyst performed—but also what conclusions the analyst developed after performing those procedures. In other words, the work papers and the report should document the analyst's thought process and rationale.

Ideally, the functional analysis work papers and report should be sufficient to allow another analyst (or the report reader) to:

1. replicate the data gathered, the procedures performed, and the considerations made;
2. duplicate the analyst's thought process and decision-making; and
3. recreate the analyst's opinions and conclusions.

A well-documented set of work papers and a well-documented report (written or oral) will accomplish these objectives related to the functional analysis. And, these documentation objectives apply to a valuation or a damages or transfer price analysis.

Summary and Conclusion

Many observers associate a functional analysis with a transfer price determination, and particularly with a transfer price analysis performed for Section 482 compliance purposes. Section 482 relates to the allocation of income and deductions related to the intercompany transfers of tangible property, intangible property, or services.

Certainly, a functional analysis is an important component of a transfer price analysis. However, experienced analysts understand that a functional analysis is also an important component of a valuation estimate and a damages measurement.

In fact, a functional analysis is relevant any time the analyst needs to (1) thoroughly understand the subject entity and, in particular, to (2) thoroughly understand the value drivers that affect the subject entity.

In addition, a functional analysis is relevant when the analyst needs to understand:

1. both the various functions that are performed at the entity and the relative importance of these functions;
2. the various assets employed at the entity—including the working capital assets, the tangible assets, and the intangible assets; and
3. the various risks assumed by the entity operations—including operational risks, financial risks, dependence risks, litigation risks, and other risks.

And, all of these factors are important to any analyst performing a valuation, damages, or transfer price analysis.

This discussion considered what is (and what is not) a functional analysis, and this discussion considered the reasons to perform the functional analysis. This discussion summarized the applications of a functional analysis within a valuation, damages, or transfer price determination.

In addition, this discussion summarized the many considerations made by the analyst into what was called the 12 steps of conducting the functional analysis.

Finally, this discussion considered the various types (or categories) of professionals who may be involved in developing the functional analysis. And, this discussion described the documentation guidelines related to the functional analysis. These documentation guidelines relate to both the analyst's work papers and the analyst's report—either written or oral.

That is, this discussion summarized the analyst's basic considerations of the functional analysis within the context of developing a valuation, damages, or transfer price opinion.

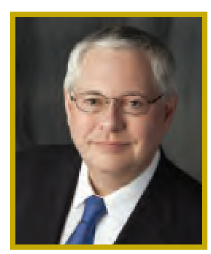

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Exhibit 1
Functional Analysis Considerations
Related to Valuation, Damages, or Transfer Price Analyses

I. Organization considerations
   A. Type of entity
      1. Description of whether the subject is a business entity, ownership interest, tangible property, or intangible property
      2. Description and documentation of ownership of subject entity
      3. Description of legal structure of entity
      4. Description of tax structure of entity
      5. Description of any ownership relationships with related parties, applicable parties, or other common ownership
      6. Description of corporate governance (e.g., board of directors)
      7. Description of operational executive or management structure (e.g., management organization chart)
      8. Description of operational functions structure (e.g., departmental organization chart)
      9. Description and locations of owned tangible property
      10. Description and locations of leased tangible property
   B. Entity documents
      1. Organization documents (e.g., articles of the corporation)
      2. Operational documents (e.g., partnership agreements, member agreements)
      3. Entity ownership documents (e.g., shareholder agreements, buy/sell agreements)
      4. Asset ownership documents (e.g., deeds, legal descriptions, licenses, leases)
      5. Entity transferability documents (e.g., franchise agreement restrictions, regulated industry considerations)
      6. Ownership interest transferability considerations (e.g., security puts and calls)
      7. Recent board of directors or executive/management committee minutes
      8. Copies of any business or operating permits or certificates
      9. Copies of any inbound or outbound intellectual property licenses
      10. Copies of any joint venture, joint development, joint commercialization, etc., agreements
      11. List of registrations of all intellectual property, including domestic and international patents, copyrights, and trademarks
      12. Copies of documents that illustrate the entity's use of domestic and international patents, copyrights, trademarks, and trade names
II. Operations considerations
   A. Operational functions
      1. Description of products produced and services provided
      2. Description of how products and services are designed, developed, or engineered
      3. Description of raw materials inputs (sources, costs, and logistics of supply and supply chain risks)
      4. Description of labor inputs (sources, costs, and logistics of supply and supply chain risks)
      5. Description of overhead (operating expense inputs) (sources, costs, and logistics of supply and supply chain risks)
      6. Description of product manufacturing or service production process
      7. Description of production scheduling and quality control procedures
      8. Description of product warehousing and in-process service storage
      9. Description of product warranty and product return risk elements
      10. Description of product and services shipping and delivery logistics

Exhibit 1 (continued)
Functional Analysis Considerations
Related to Valuation, Damages, or Transfer Price Analyses

11. Description of how intellectual property (patents, copyrights, trademarks, and trade secrets) are developed, documented, and registered
12. Description of how intellectual property (patents, copyrights, trademarks, and trade secrets) are commercialized and protected

B. Administrative functions
1. Description of accounting functions
2. Description of receivables/cash collection function and payables/cash disbursement function
3. Description of treasury (cash management and banking relationship) function
4. Description of capitalization, capital structure, and financing functions
5. Description of product/service design and engineering function
6. Description of production engineering/service delivery efficiency function
7. Description of advertising and market research function
8. Description of packaging and branding function
9. Description of human resources, recruiting, training, benefits function
10. Description of general counsel function
11. Description of information technology, management information function
12. Description of regulatory compliance and other compliance functions

C. Competition and competitive position functions
1. Listing and description of principal competitors
2. Approximate size of principal competitors
3. Ranking of principal competitors by market share and relative market share
4. Product/service features differentiation with competitors
5. Product/service pricing differentiation with competitors
6. Product/service distribution differentiation with competitors
7. Product/service intellectual property differentiation with competitors
8. Description of total market size
9. Description of total market growth rate
10. Description of how customers use the entity's product/service

D. Risk/expected return considerations
1. Description of materials source of supply risk
2. Description of labor source and supply risk
3. Description of operating leverage (fixed costs coverage) risk
4. Description of financing leverage (debt service coverage) risk
5. Description of tangible property risk
6. Description of environmental risk
7. Description of litigation risk
8. Description of intellectual property risk
9. Description of customer concentration risk
10. Description of executive concentration risk
11. Description of regulatory change risk
12. Description of product/service liability risk

Exhibit 1 (continued)
Functional Analysis Considerations
Related to Valuation, Damages, or Transfer Price Analyses

III. Financial Considerations

A. Accounting principles and financial statements

1. Descriptions of current accounting principles applied
2. Comparison of entity accounting principles to competitor accounting principles
3. Description of recent changes in accounting principles applied
4. Discussion of revenue recognition principles
5. Discussion of expense recognition principles
6. Discussion of taxation accrual and deferred tax principles
7. Discussion of tangible asset capitalization and depreciation principles
8. Discussion of intangible asset recognition principles
9. Discussion of liability recognition principles
10. Discussion of any adjustments to capital accounts
11. Discussion of cash flow statement working capital adjustments
12. Discussion of cash flow statement noncash revenue and expense account
13. Discussion of cash flow statement investment adjustments
14. Discussion of cash flow statement financing adjustments

B. Financial statement projection considerations

1. Description of the term (time period) of any financial projections
2. Description of the level of detail included in any financial projections
3. Description of financial projections development procedures
4. Description of financial projections review procedures
5. Comparison of financial projections to historical financial statements
6. Comparison of financial projections to guideline company financial projections
7. Comparison of financial projections to industry financial projections
8. Comparison of historical financial projections to historical financial statements for prior projection periods
9. Copies of any strategic plans or competitive analyses
10. Copies of any debt service payment projections (including any considerations of liquidity or solvency)

C. Valuation considerations

1. Description of the process for selecting guideline public companies
2. Procedures for assessing the subject entity comparability to guideline public companies
3. Procedures for adjusting the financial data of guideline public companies
4. Description of the process for selecting guideline M&A transactions
5. Procedures for assessing the comparability of the subject entity to guideline M&A transactions
6. Procedures for adjusting the financial data of guideline M&A transactions
7. Description of any recent offers to buy the entity or the entity's securities
8. Description of any recent sales (or other exchanges) of the subject entity or the entity's securities
9. Descriptions of any value indications (including historical development costs) of tangible real property and tangible personal property
10. Descriptions of any value indications (including historical development costs) of general commercial intangible assets and of intellectual property

Exhibit 1 (continued)
Functional Analysis Considerations
Related to Valuation, Damages, or Transfer Price Analyses

IV. Assets employed and SWOT/risks assumed considerations
   A. Assets employed
      1. Description of—and use of—cash and marketable securities
      2. Description of—and use of—accounts receivable
      3. Description of—and use of—prepaid expenses
      4. Description of—and use of—inventory accounts
      5. Description of—and use of—other current asset accounts
      6. Description of—and use of—land and buildings
      7. Description of—and use of—tangible personal property
      8. Description of—and use of—other tangible assets
      9. Description of—and use of—intellectual property assets
      10. Description of—and use of—other identifiable intangible assets
      11. Description of—and use of—intangible value in the nature of goodwill
      12. Description of—and use of—nonoperating or investment assets
      13. Description of—and use of—current liabilities
      14. Description of—and use of—long-term interest-bearing debt
      15. Description of—and use of—other long-term liabilities
      16. Description of—and use of—contingent liabilities
   B. SWOT and risks assumed considerations
      1. List of principal competitive strengths
      2. Description of how competitive strengths affect the entity operating results
      3. Description of how competitive strengths affect the entity risks
      4. List of the principal competitive weaknesses
      5. Description of how competitive weaknesses affect operating results
      6. Description of how competitive weaknesses affect the entity risks
      7. List of the principal competitive opportunities
      8. Description of how competitive opportunities affect the entity's operating results
      9. Description of how competitive opportunities affect the entity risks
      10. List of principal competitive threats
      11. Description of how the principal competitive threats affect operating results
      12. Description of how the principal competitive threats affect the entity's risks

Exhibit 2
12 Steps in the Performance of a Functional Analysis Related to a Valuation, Damages, or Transfer Price Conclusion

1. Gather and review all relevant entity legal documents.

   (This step includes documents regarding organization structure, legal firm, tax status, and owners—e.g., shareholder, partnership, LLC member—agreements.)

2. Gather and review all relevant entity organization charts.

   (This step includes both personnel reporting charts and functional relationship clients and considers both entity governance procedures and quality, quantity, tenure, and experience of entity/function leaders.)

3. Understand and document the product/services design, R&D, and product/services differentiation functions.

   (This step includes the assessment of how the entity's products or services are developed and how these products or services are intended to address their competition in the relevant marketplace.)

4. Understand and document the materials, labor, and overhead procurement function.

   (This step includes consideration of how and when the entity procures all of its materials, labor, and overhead inputs—for entities in every type of industry or profession.)

5. Understand and document the product/services production function.

   (This step includes the assessment of how the entity processes all of its material, labor, and overhead components to produce a product or a service—including the quality control of the product or service production.)

6. Understand and document the inventory and product/service storage function.

   (This step includes both the in-process and finished inventory of goods and the in-process and finished inventory of services.)

7. Understand and document the sales and marketing function.

   (This step includes the assessment of the product or service pricing, packaging, advertising, promotional, trademark development and protection, and other branding—on a stand-alone basis and in response to competitive products and services.)

8. Understand and document the shipping and distribution logistics function.

   (This step includes consideration of how the product or service is delivered to the customer or client—including freight, insurance, returns, warranty and repairs, and other expenses.)

9. Understand and document the accounting, finance, information systems, human resources, legal, and other administration functions.

   (This step includes the assessment of how (a) information is generated and used throughout the organization, (b) human resources are developed and administered, (c) financial statements and operational documents are prepared and used, (d) how cash management and treasury operations are performed, and (e) how the entity is capitalized with debt and equity capital sources.)

10. Assess and document the entity's strategic position in comparison to competitors in an industry or profession.

    (This step includes (a) measurement of the entity's market share/selective market share, market size, and market growth rate; (b) evaluation of the entity's customer or client needs; and (c) assessment of the entity's competitive strengths, weaknesses, opportunities, and threats.)

11. Describe and document the assets used by the entity to perform the functions.

    (This step includes a listing, description, and assessment of relative importance/contribution of (a) all working capital accounts, (b) all tangible property types and accounts—owned and leased, and (c) all general intangible property types and accounts—owned and licensed, and (d) all intellectual property types and accounts—owned and licensed.)

12. Evaluate and document the risks assumed by the entity to perform the functions.

    (This step includes a listing, description, and assessment of all product/service liability, operating language, financial leverage, environmental, supply dependence, customer dependence, technology dependence, employee dependence, intellectual property dependence, tax litigation, commercial litigation, credit and collection, inventory control, property and casualty, foreign exchange, market/competitor, and other risks.)

Guide to Intangible Asset Valuation

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Subsequent Events in Gift and Estate Tax Valuations

Ben R. Duffy and Weston C. Kirk

Subsequent events are sometimes considered in the development of a business valuation. This statement is true for business valuations that are developed retrospectively. Events which take place after the valuation date may require special consideration based on analysis-specific circumstances. This discussion provides guidance to understand how and when subsequent events may—or may not—be considered in a business valuation prepared for federal gift and estate tax planning, compliance, or litigation purposes.

Introduction

This discussion outlines the considerations of subsequent events in the valuation of businesses, business interests, and intangible assets for federal gift and estate tax purposes. Although not explicitly discussed, the topics addressed herein can be extrapolated for federal generation-skipping transfer tax purposes as well.

A valuation date is the specific date at which the analyst estimates the value of a subject investment interest. The valuation date may be considered one of the most important inputs of the analysis.

For gift tax purposes, the appropriate valuation date is the date of the taxable transfer. For estate tax purposes, the appropriate valuation date is either the date of death or the alternate valuation date (six months after the date of death).

Valuations involving federal tax matters are typically based on the fair market value standard of value. Fair market value is generally interpreted to be based on the consideration of information that was known or knowable as of the valuation date. In other words, the analyst's consideration of subsequent events that were not known or knowable as of the valuation date is generally inconsistent with the fair market value standard of value.

However, there are instances in which subsequent events have been relied on by the U.S. Tax Court ("Tax Court"). Therefore, the analyst should consider analysis-specific facts and circumstances when considering the inclusion of subsequent events to the valuation date in each valuation analysis.

The Tax Court, as well as the valuation professional organizations ("VPOs"), has provided guidance regarding the consideration of subsequent events. Generally, opinions of value only reflect circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date; such an occurrence is typically referred to as a subsequent event.

Subsequent Event Valuation Standards

Valuation analysts sometimes consider subsequent events in valuation analyses. Whether or not such subsequent events are considered in a specific valuation analysis is based on the facts and circumstances. Those facts and circumstances are influenced by the Internal Revenue Code, the Treasury regulations, and the relevant federal judicial precedent.

Additionally, analysts are required to comply with various professional standards of which they are members. Various VPOs issue professional standards and professional guidance for their members. These standards and guidance influence the analyst's consideration of subsequent events. The following discussion summarizes (1) the applicable tax statutory and judicial guidance and (2) the VPO standards and guidance.

Statutory and Judicial Guidance

Most Tax Court cases that involve subsequent events have concluded that it is inappropriate to rely on subsequent events as direct evidence of value as of the valuation date. That is, if a security is transacted after the valuation date, it is generally not appropriate to simply use that transaction price for a valuation analysis prior to that event occurring.

However, the Tax Court has also found, in some instances, that certain subsequent events that occur within a reasonable time period after the valuation date may be appropriate to consider in the determination of fair market value as of the applicable valuation date.

The Tax Court determines cases that involve U.S. federal tax matters. In these tax matters, valuation issues are typically determined under the standard of value of fair market value.

For U.S. federal gift tax purposes, fair market value is defined in Regulation 25.2512-1, as follows:

> The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property made the subject of a gift, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail . . . . All relevant facts and elements of value as of the time of the gift shall be considered.

Regulation 20.2512 governs that the applicable valuation date is when the gift is made. According to the regulations, the value of property transferred shall be measured as of the date the property is transferred.

For U.S. federal estate tax purposes, fair market value is similarly defined in Regulation 20.2031-1(b), as follows:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail.

Regulation 20.2031 governs that the applicable valuation date is the time of the decedent's death, except if the executor elects the alternate valuation method under Regulation 2032(a).

Regulation 20.2032(a) allows the executor of an estate to elect that the gross estate be valued for estate tax purposes at the alternate valuation date (rather than the date of death) if (and only if) (1) the gross estate has a lower fair market value on that alternate valuation date and (2) the sum of tax imposed with respect to the property includible in the decedent's gross estate is lower under Regulation 20.2032(c).

The alternate valuation date is determined as six calendar months after the date of death. So, for example, if the decedent died on April 15, the alternate valuation date would be October 15.

For valuation purposes, Regulation 20.2032(a) states:

> The value of gross estate may be determined, if the executor so elects, by valuing

all the property included in the gross estate as follows:

> (1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.
>
> (2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.
>
> (3) Any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time.

Therefore, generally, for investment interests held through the alternate valuation date for estate tax purposes, events that occurred during the "lapse of time" are includable in the valuation analysis.

Internal Revenue Service Revenue Ruling 59-60 provides guidance regarding the valuation of the stock of closely held corporations and the stock of corporations where market quotations are not available. A revenue ruling is an official interpretation by the Internal Revenue Service (the "Service").

According to Revenue Ruling 59-60, valuations for gift and estate tax purposes should determine fair market value based on the circumstances of each case. The analyst "should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science."

Supportable valuations "will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

Further, the "[v]aluation of securities is, in essence, a prophecy as to the future and must be based on facts available at the required date of appraisal." Subsequent events may be confirming evidence to the "prophecy as to the future" in a valuation analysis

The following selected Tax Court determinations provide examples for when subsequent events were both relied on and ignored by the Tax Court. These examples further support the argument for an analyst to consider subsequent events on a case-by-case basis.

Estate of Gilford

In the *Gilford* decision,[1] the Tax Court excluded a subsequent event transaction as the indication of fair market value as of the valuation date.

On November 17, 1979, Saul Gilford died unexpectedly. Mr. Gilford held 381,150 shares (approximately 23 percent) of Gilford Instrument Laboratories, Inc. ("GIL"), stock. Mr. Gilford was also the chairman and chief executive officer of GIL.

The Gilford estate timely filed its estate tax return, electing not to use the alternate valuation date, and reported the value of the GIL stock at $7.35 per share.

GIL stock was actively traded in the over-the-counter market, however, the GIL stock held by Mr. Gilford was restricted under federal securities law. Since Gilford's death occurred on a Saturday, the taxpayer's analyst estimated the value of the GIL stock based on the average of the mean trading price from the preceding Friday and the subsequent Monday.

The taxpayer's analyst arrived at a price of $11.31 per share. However, the value of the stock was discounted by 35 percent in order to account for (1) the size of the block of stock and (2) the restricted nature of the stock.

In a notice of deficiency, the Service determined the fair market value of the GIL stock to be $24.00 per share as of the date of death. This price was based solely on a merger consideration that occurred on May 30, 1980 (195 days after the valuation date). The Service argued that the merger was foreseeable to the estate as of the date of Mr. Gilford's death.

In this case, the Tax Court stated the following:

> In general, property is valued as of the valuation date on the basis of market conditions and facts available on that date WITHOUT REGARD TO HINDSIGHT. However, we have held that postmortem events can be considered by the Court for the "limited purpose" of establishing what the willing buyer and seller's expectations were on the valuation date and whether these expectations were "reasonable and intelligent." *Estate of Jephson v. Commissioner*, 81 T.C. 999 (1983). The rule that has developed, and which we accept, is that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation.

Evidence supported the fact that GIL planned to maintain operations and was not soliciting a sale as of the date of Gilford's death. Additionally, the GIL board of directors did not hire an investment bank to investigate financial alternatives until January 2, 1980.

The Tax Court determined the following:

> On November 17, 1979, there was no reasonable or intelligent expectation that a merger of [GIL] or a sale of petitioner's block of stock between a willing buyer and a willing seller for $24 per share would take place.

Ultimately, the Tax Court concluded that the subsequent event should not be included in determining fair market value as of the date of death and concluded the fair market value of the GIL stock to be $7.58 per share—slightly higher than the taxpayer's original filing. This value determination was based on the historical over-the-counter trading prices and a downward valuation adjustment of 33 percent to account for (1) the size of the block of stock and (2) the restricted nature of the stock.

Based on the *Gilford* decision, transactions which were not reasonably foreseeable as of the valuation date may not be acceptable for providing fair market value indications. It is also important to note that the presence of an active market for the GIL stock further supported the omission of the subsequent event merger price consideration as an indication of value as of the date of death valuation date.

Ringgold Telephone Company v. Commissioner

In the *Ringgold* decision,[2] the Tax Court relied on the value indication of a subsequent event transaction in order to determine fair market value as of the valuation date.

In this case, the Tax Court opined on the fair market value of a 25 percent partnership interest in Cellular Radio of Chattanooga ("CRC") for built-in gain tax purposes. On the valuation date, the Ringgold Telephone Company ("Ringgold") elected to be taxed as a subchapter S corporation for federal income tax purposes.

Prior to the valuation date, Ringgold was taxed as a C corporation. On November 27, 2000, approximately 11 months after the valuation date, the subject interest was sold.

To limit the benefits that can be obtained by converting a C corporation to an S corporation, IRC Section 1374 imposes a corporate level tax on S corporations that formerly were C corporations. At that time, this tax is imposed on any gain (1) that arises before the effective date of the S election (i.e., the built-in gain) and (2) that is recognized by the S corporation within 10 years after the conversion due to a sale or distribution of its assets.

At trial, two valuation analysts presented valuation evidence regarding the fair market value of the 25 percent interest in CRC. One analyst testified for the taxpayer, and one analyst testified for the Service.

The taxpayer's analyst determined the fair market value of the interest in CRC at $2,980,000 as of the valuation date. The Service's analyst determined the fair market value of the interest in CRC at $5,155,000.

During July 2000, approximately six months after the valuation date, the taxpayer and BellSouth entered into an agreement for the sale of the subject interest. The transaction was finalized on November 27, 2000, for $5,220,043.

The Service contended that the fair market value of the subject interest was $5,220,423, based on the transaction price and the Service analyst valuation report.

The Tax Court placed equal weight on (1) the taxpayer's analyst concluded value for CRC based on the capitalization of income method, the discounted cash flow method, the guideline publicly traded company method, and the guideline merged and acquired company method of $2.718 million; (2) the taxpayer's analyst concluded value for CRC based on the capitalization of distributions analysis of $3.243 million; and (3) the BellSouth sale price of $5.220 million.

The Tax Court held that the fair market value of the subject interest was $3,727,141, based on consideration of both (1) the taxpayer's analyst conclusion and (2) the transaction price subsequent to the valuation date.

Before applying emphasis to the BellSouth transaction, the Tax Court considered whether the sale was within a reasonable time after the valuation date.

According to the Tax Court, "the price at which the CRC interest sold was fixed by a formula agreed to 6 months after the valuation date . . . neither party asserts the sale date was not within a reasonable time after the valuation date. We conclude, on the basis of the record, that the sale of the CRC interest to BellSouth occurred within a reasonable time after the valuation date."

Next, the Tax Court considered whether there were any events between the valuation date and the sale date that would have affected the value of the CRC interest.

According to the Tax Court, "Petitioner has not established, and does not argue, that there were intervening circumstances that would have affected value between the valuation date and the sale date . . . . We conclude . . . that there were no intervening events that would have affected value between the valuation date and the sale date."

Based on the *Ringgold* decision, an analyst may consider (1) if a post-valuation date transaction was within a reasonable time frame after the valuation date and (2) if any events occurred between the valuation date and the transaction that would have affected the value of the subject interest.

Valuation Professional Organizations Standards and Guidance

The Appraisal Institute develops and promulgates real estate valuation professional standards. The Appraisal Institute Board of Directors adopted the Appraisal Institute *Standards of Valuation Practice* effective January 1, 2015. These standards are designed so that appraisals (and appraisal reviews) are credible and that appraisal (and appraisal review) reports are credible and not misleading.

The Appraisal Institute issued *Guide Notes to the Standards of Professional Practice of the Appraisal Institute*, noting the following with respect to subsequent events:[3]

> [A]ppraisers are not expected to be prognosticators. Unforeseen events can completely eradicate conclusions that have been based in trend analysis or fundamental market analysis. A market value opinion is as of a particular date, and it is an attempt to reflect the anticipations of market participants as well as market fundamental trends and analysis. Events subsequent to the date of value that were not anticipated by market participants can cause values to change—in some cases, significantly.

The Appraisal Foundation is authorized the U.S. Congress as the source of appraisal standards and appraiser qualifications. The Appraisal Standards Board of the Appraisal Foundation developed the *Uniform Standards of Professional Appraisal Practice* ("USPAP").

USPAP Standards 9 and 10 relate to (1) developing and (2) reporting, respectively, a business or intangible asset valuation. Neither standard references the inclusion or exclusion of subsequent events in a business valuation analysis directly.

However, USPAP Advisory Opinion 34 states the following:[4]

> Data subsequent to the effective date may be considered in developing a retrospective value as a confirmation of trends that would reasonably be considered by a buyer or seller as of that date. The appraiser should determine a logical cut-off for the data to be used in the analysis because at some point distant from the effective date, the subsequent data will no longer provide an accurate representation of market conditions as of the effective date. This is a difficult determination to make. Studying the market conditions as of the date of the appraisal assists the appraiser in judging where to make this cut-off. With market evidence that data subsequent to the effective date was consistent with market expectations as of the effective date, the subsequent data should be used. In the absence of such evidence, the effective date should be used as the cut-off date for data considered by the appraiser.

Advisory Opinions are issued to illustrate the applicability of appraisal standards in specific situations and to offer advice from the Appraisal Standards Board for the resolution of appraisal issues and problems, and such opinions are not intended to interpret or establish new standards.

Under USPAP guidance, information (including data) that becomes available after the valuation date may be considered in developing a retrospective value as a confirmation of trends. And, the analyst is instructed to determine a logical cut-off date for incorporating retrospective information. However, subsequent information should be consistent and confirmatory with market expectations and conditions that existed as of the valuation date. Most VPOs give flexibility to the analyst to make the decision of including or excluding a subsequent event in a valuation.

Unlike USPAP and other valuation standards, the American Institute of Certified Public Accountants ("AICPA") standards with respect to subsequent events are more restrictive, noting that subsequent events are deemed to be not known or knowable as of the valuation date and should, therefore, be excluded from the analysis.

The AICPA publishes standards for its members. The AICPA Statement on Standards for Valuation Services, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* ("VS Section 100") establishes valuation standards that are mandatory for all AICPA members who are engaged to estimate the value of a business, business ownership interest, security, or intangible asset.

Paragraph 43 of VS Section 100 discusses subsequent events, as follows:[5]

> The valuation date is the specific date at which the valuation analyst estimates the value of the subject interest and concludes on his or her estimated value. Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date: such an occurrence is referred to as a subsequent event. Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or condition. Moreover, the valuation would typically not include a discussion of those events or conditions because a valuation is performed at a point in time—the valuation date—and the events described in this subparagraph, occurring subsequent to that date, are not relevant to the value determined as of that date. In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure in a separate section of the report in order to keep users informed.

Disclosing Subsequent Events in Valuation Reports

Generally, subsequent events do not need to be explicitly discussed in a valuation report for gift and estate tax purposes. That is because analysts have generally accepted that events that occur after a valuation date are not required to be disclosed in a valuation report as of a specific valuation date.

Analysts have accepted that if all of the facts and circumstances that an investor would inquire about up to and as of the valuation date are disclosed in the valuation report, the reasonableness standard of disclosure is met.

In some cases, it may be prudent to disclose subsequent events. These disclosures are often to inform the reader about a subsequent event and how that event may (or may not) affect the conclusion reached as of the valuation date.

Disclosing a subsequent event may be appropriate for providing adequate disclosure in a valuation report for U.S. federal gift and estate tax purposes. The term "adequate disclosure" is defined and its requirements are set forth in Regulation 301.6501(c)-1(f)(3). This regulation section references subsequent events indirectly in that "[i]n order to satisfy the adequate disclosure requirements, the business valuation report must meet the following requirements . . . [t]he appraisal contains . . . [t]he information considered in determining the appraised value…that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value."

USPAP does not require the disclosure of subsequent events in a valuation report. However, if a subsequent event is used as confirmatory evidence to an estimate of value, that subsequent event should be clearly disclosed and discussed how it was used in the valuation analysis.

The AICPA standards permit that if a subsequent event is meaningful to be understood by the reader of the report, then a separate section of the report (e.g., an appendix to the narrative report) should disclose the subsequent event and how that information was not included in the valuation analysis as of a certain valuation date.

This disclosure is also required to be stated for informational purposes only. AICPA VS Section 100 specifically notes that only information known or knowable as of the valuation date should be considered.

Under VS Section 100 paragraph 43, subsequent events are permitted to be disclosed in a valuation report if such disclosure is deemed to be meaningful to the user of the report.

However, subsequent event disclosures that do not bear on the results of the analysis must be included in a separate section of the report and must clearly state that such disclosures are provided for "informational purposes only and do not affect the determination of value as of the specified valuation date."[6]

So, if information was (1) used that occurred subsequent to the valuation date and (2) used to determine fair market value, that information has to be presented and disclosed in such a way that it is clear and understood by the reader.

When evaluating subsequent events, valuation analysts ought to consider what was known or knowable as of the valuation date. The analyst should analyze the market conditions as of the valuation date.

If subsequent events (e.g., data, information, transactions) are supportive of trends that were prevalent as of the valuation date, and such subsequent event is informative to the valuation of the subject interest, then the guidance by the Code, the Tax Court, and USPAP allow for the inclusion of such subsequent event at the direction of the analyst.

VS Section 100 does not permit the inclusion of subsequent events, but it permits the disclosure of subsequent events for informational purposes only.

In situations where this type of information exists and is included or excluded in the analysis, the analyst should document the support and analysis clearly in the narrative report. The analyst should be prepared to support why (or why not) those subsequent events should (or should not) be included (or excluded) as known or knowable as of the valuation date.

Business Valuation Case Examples

The following business valuation case examples illustrate suggestions in how subsequent events may (or may not) be used in a valuation. These examples are presented for illustrative purposes only.

Each valuation analysis is unique and the facts and circumstances will decide whether subsequent event information should (or should not) be included in a valuation.

Example 1: Economic Market Shock

One of the most recognized subsequent events is an economic shock that affects publicly traded marketplaces.

As an example, if the S&P 500 index declines the day after the valuation date, the valuation analyst generally would not include that following day market pricing evidence on the prior day valuation date. That difference—whether higher or lower—generally would not affect the analysis as of the valuation date, and the trading prices (and current market conditions) as of the valuation date would apply.

However, in some situations as noted below (but not limited solely to the below), the analyst may adopt post-transaction-date market shock information in an analysis as of a valuation date.

In certain situations, such as in valuing publicly trading securities and publicly traded bonds for gift tax and estate tax reporting purposes, the valuation may incorporate post-valuation-date trading price information.

For gift tax reporting purposes, under Regulation 25.2512-2(b)(1), if there are no sales of the stock listed and traded on a public market on the date of gift, but there are sales within a reasonable period both before and after the date of the gift, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the date of the gift. The average is to be weighted inversely by the respective number of trading days between the selling dates and the date of the gift—thus, including post valuation date information.

Similarly, under Regulation 25.2512-2(b)(2), if there were no sales of a bond traded on a public exchange within a reasonable period before or as of the date of the gift, the fair market value is determined by taking a weighted average of the quoted closing selling prices on the nearest date before and the nearest date after the date of the gift.

For estate tax purposes, similar rules apply under Regulations 20.2031-2(b)(1) and 20.2031-2(b)(2), respectively. And, for estate tax purposes, economic market shocks may be considered in the valuation of securities if the alternate valuation date applies under Regulation 20.2032(a).

Example 2: Black Swan Events

Generally, black swan events that affect valuation subsequent to the valuation date are not included in a valuation. Black swan events are defined as an unpredictable event that occurs beyond what is normally expected and has a significant consequence.

Black swan events over recent history include the September 11, 2001, terrorist attacks; the Lehman Brothers collapse and the subsequent Great Recession, and the COVID-19 pandemic.

For gift tax purposes, subsequent black swan events are unlikely to be included in a retrospective valuation analysis as of the date of gift transfer.

For estate tax purposes, the estate may elect to value the estate as of the alternate valuation date under Regulation 20.2032(a). If the subsequent black swan event occurred after the valuation date and has a negative value impact on the gross estate value six months after the date of death, the executor can elect to incorporate the effects of the black swan event on the estate assets by electing the alternate valuation date.

For estate tax purposes, under Regulation 20.2032(a), if the assets of the estate are sold during the black swan event impact and the estate makes the alternate valuation date election, the sale proceeds of those transactions would be used for estate tax filing purposes. Thus, the black swan event would be appropriate to include in the alternate valuation date analysis.

Example 3: Subsequent Securities Transaction

In some instances, a subsequent securities transaction may be the best indication of fair market value as of the valuation date. Subsequent securities transactions may be in the form of a merger or acquisition, an initial public offering ("IPO"), or the private sale of a comparable ownership interest. For instance, even if a subsequent transaction occurs after the valuation date of the taxable transfer, there may be an argument for incorporating the sale into the valuation analysis.

For example, in the *Thompson* decision,[7] the Tax Court stated, "if comparable sales occur after the death of decedent, there is no sound reason to ignore them."

The Tax Court has opined that when a subsequent sale is relied on in the estimation of the fair market value, it is necessary to adjust the subsequent sale price for events between the valuation date and the subsequent sale date that affect the subsequent sale price.

For example, in the *Noble* decision,[8] the Tax Court stated the following:

> When a subsequent event is used to set the fair market value of property as of an earlier date . . . adjustments should be made to the sale price to account for happenings between the two dates which would affect the later sale price; these happenings include (1) inflation, (2) changes in the relevant industry and the expectations for that industry, (3) changes in business component results, (4) changes in technology, macroeconomics, or tax law, and (5) the occurrence or nonoccurrence of any event which a hypothetical reasonable buyer or a hypothetical reasonable seller would conclude would affect the selling price of the property subject to valuation (e.g., the death of a key employee).

In the event that there is an IPO after the valuation date, an analyst should at least consider (although, not necessarily rely on) the indicated value of the IPO in the valuation analysis. The Tax Court has rejected expert testimony which has not taken into account the circumstances of future public sales.

For example, in *Silverman*,[9] the Tax Court rejected the expert testimony presented by the taxpayers since the analyst failed to take into account the circumstances of a future public offering, even though the subject stock was in the process of reorganizing with the intent to go public as of the valuation date.

Example 4: Revised Projections/ Forecast/Budget

Financial statement projections are one of the primary inputs in several generally accepted business valuation methods. Financial statement projections directly influence the discounted cash flow method of the income approach and often influence the market approach (either through the use of projected pricing multiples or by adjusting historical pricing multiples based on the subject company's growth expectations).

A recurring dilemma that a valuation analyst faces is whether to consider financial projections, forecasts, or budgets produced after the valuation date. In some instances, financial projections prepared after the valuation date may be the only projections available. Therefore, the analyst may interview company management and conduct the proper due diligence in order to determine if the projections would have a been a reasonable estimate of future income as of the valuation date.

For illustrative purposes, for example, John Smith owns a business which manufactures hotel bedding ("Hbed Inc.") with one major client who accounts for approximately 90 percent of the Hbed Inc. revenue.

On January 1, 2020, Mr. Smith decides to gift a 20 percent interest in Hbed Inc. to a trust. However, one month later, a client which accounted for 90 percent of the Hbed Inc. revenue decides to no longer buy hotel bedding from Hbed Inc. Afterwards, Hbed Inc. management prepares projections for its lender which include a 90 percent year-over-year decrease in revenue.

The analyst may then consider how to incorporate the projections for the valuation of a 20 percent interest in Hbed Inc. as of January 1, 2020.

In this case, the analyst may avoid relying on the revised projections since they included an unforeseeable event that occurred after the valuation date. However, this event may bring more light to the customer concentration risk that a hypothetical willing buyer and hypothetical willing seller would have considered as of the valuation date.

Therefore, the analyst may incorporate customer concentration risk in the analysis and the subsequent event may support the analyst's decision if challenged in the Tax Court. In this instance, the analyst may consider only relying on historical financial results.

In order to effectively capture the significant customer concentration risk, the analyst may increase the present value discount rate or apply a discount to the company's equity value interests.

Example 5: Loss of a Key Employee

The operations, and underlying value, of a business may be influenced by a key employee. Consequently, the death, disability, or departure of a key employee may detrimentally affect a business's operations.

The presence of a key employee is more common in smaller companies since upper level management is comprised of relatively few employees. In such circumstances, it is possible that the future success of the company is affected by the continued health, success, and contributions of its key leaders and employees.

During due diligence procedures, the analyst may identify key employees and the implications of their sudden departure.

The following six areas may be analyzed to determine whether key person risk is present: (1) management and leadership skill, (2) supplier relationship, (3) customer relationship, (4) innovation skill, (5) debt or equity financing, and (6) employee loyalty.[10]

In the instance that an identified key employee unexpectedly dies, becomes disabled, or departs the subject company after the valuation date, the analyst may still value the company as if the employee were still present.

However, the analyst may incorporate the key person risk in the analysis by adjusting company earnings (historical or projected), adjusting the present value discount rate or capitalization rate, adjusting market based trading pricing multiples, or applying a key person discount at the company level.

Example 6: Legal or Regulatory Event

A single legal or regulatory change may affect the operations or cash flow of a business in a material way. These events can sometimes be anticipated as they are being proposed. However, the analyst is given the difficult task of determining how to incorporate such potential event into the valuation analysis.

In order to incorporate a legal or regulatory event, the analyst should consider what information regarding such event was available as of the valuation date. For example, how should an analyst consider the impact of a tariff which was imposed after the valuation date?

In this case, the analyst may want to ask the following questions: Had the tariff already been proposed as of the valuation date? How likely was the tariff to be implemented after the valuation date? Would a hypothetical willing buyer and hypothetical willing seller consider the operational risk associated with the tariff as of the valuation date?

If the analyst determines that a hypothetical willing seller and buyer would have considered the operational risk associated with the tariff as of the valuation date, then the analyst may decide to incorporate this risk in the valuation analysis.

The analyst may decide to adjust the present value discount rate to account for the additional risk associated with the potential tariff. The analyst may also consider a scenario analysis in which income is projected based on each prospective outcome.

For example, Scenario A projects that the tariff is never imposed and Scenario B projects that the tariff is imposed one month after the valuation date. The analyst could then apply probability weightings to each scenario based on the information that was available as of the valuation date. However, the analyst must be careful to not apply additional weight to a certain scenario based on knowledge that was available after the valuation date.

Example 7: Change in Tax Law

A subject company's tax status and the normalized or effective tax rate of the subject company directly affect the company's cash flow and the cash flow to its stakeholders. Since the expected future cash flow of a company and its cash flow to its stakeholders is a significant input in most business valuations, existing and proposed tax laws often have valuation implications.

> "[T]he effects of subsequent events may be considered in a valuation for gift or estate tax purposes under certain circumstances. . . ."

The most recent major tax law legislation was the Tax Cuts and Jobs Act ("TCJA"), which was signed into law on December 22, 2017. This was the first major change to the Code since the Tax Reform Act of 1986.

The primary valuation-related tax changes in the TCJA that affect C corporations at the entity level are (1) the permanent reduction in the federal corporate income tax rate from a top marginal rate of 35 percent to a flat rate of 21 percent, (2) a permanent limitation on the deductibility of business interest expense, and (3) temporary accelerated ("bonus") depreciation.

The TCJA also changed the taxation of certain individuals. Individual taxation may be considered when valuing pass-through entities ("PTEs"). This is because owners of PTEs are taxed at individual tax rates based on their pro-rata share of the earnings of the PTE.

The primary valuation-related tax changes of the TCJA that affect individuals are (1) the temporary implementation of a new graduated individual income tax structure; (2) a temporary limit (in aggregate) for certain itemized deductions, including state and local taxes; and (3) a temporary 20 percent deduction of the qualified business income of PTEs.

The valuation consequences of the TCJA may be considered for any analysis with a valuation date after December 22, 2017. However, the analyst may carefully consider if it is appropriate to apply TCJA tax changes to an analysis with a valuation date prior to December 22, 2017.

In general, an analyst may elect to ignore TCJA tax changes for an analysis with a valuation date prior to November of 2017.

However, by November of 2017, there was a reasonable expectation that the TCJA would be signed into law, after its initial release by the House of Representatives on November 2, 2017. Therefore, an analyst may elect to consider certain TCJA tax changes in an analysis with a valuation date from November 2, 2017, to December 22, 2017, however, the analyst should also consider the potential risk of the TCJA not being signed into law during this period.

Summary and Conclusion

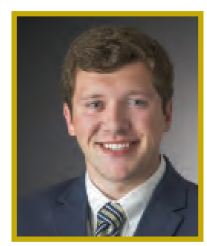
This discussion summarized the analyst considerations with respect to subsequent events for federal gift and estate tax purposes.

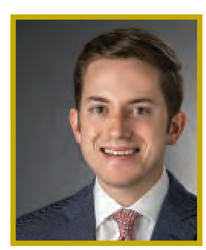
Taxpayers and analysts should understand the statutory authority, administrative rulings, and judicial precedent, as well as the VPO standards and guidance—with respect to the consideration of subsequent events for valuation purposes.

Generally, opinions of value only reflect circumstances existing at the valuation date and events occurring up to the valuation date. However, as noted above, the effects of subsequent events may be considered in a valuation for gift or estate tax purposes under certain circumstances—with appropriate considerations of the facts and circumstances that were prevalent as of the valuation date.

Notes:

1. Wurster v. Commissioner (In re Estate of Gilford), 88 T.C. 38 (1987).
2. The Ringgold Telephone Company v. Commissioner, T.C. Memo 2010-103.
3. *Guide Notes to the Standards of Professional Practice of the Appraisal Institute* (Chicago: Appraisal Institute, November 17, 2016, minor revisions in 2020).
4. Advisory Opinion 34 (AO-34), 2020-2021 *Uniform Standards of Professional Appraisal Practice*, Effective January 1, 2020, through December 31, 2021 (Washington: The Appraisal Foundation, 2020), 156.
5. VS Section 100, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (New York: American Institute of Certified Public Accountants, 2007), paragraph 43.
6. *Forensic & Valuation Services Practice Aid, Business Valuations for Estate and Gift Tax Purposes* (New York: AICPA, 2015).
7. Estate of James U. Thompson v. Commissioner, 89 TC No. 43 (1987), note 7.
8. Estate of Helen M. Noble v. Commissioner, T.C. Memo 2005-2.
9. Silverman v. Commissioner, T.C. Memo. 1974-285, *aff.d*, 538 F.2d 927 (2d Cir. 1976), *cert. denied*, 431 U.S. 938 (1977).
10. Shannon P. Pratt, *Discounts and Premiums*, 2nd ed. (Hoboken, NJ: John Wiley & Sons, Inc.), 260–1.





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What Tax Counsel Needs to Know about Working with a Valuation Specialist

Timothy J. Meinhart and Robert F. Reilly, CPA

Trust and estate counsel are often involved in the planning, compliance, and controversy matters on behalf of corporate, trust, or high net worth individual clients. These taxation matters could include both (1) gift tax, estate tax, and generation-skipping transfer tax (collectively, "transfer tax") and (2) income tax matters. These transfer tax and income tax matters often involve the valuation of a private company, business ownership interest, security, or intangible asset. This discussion provides everything that trust and estate counsel need to know about selecting and working with a valuation specialist in such transfer tax or income tax matters.

Introduction

Trust and estate tax counsel ("counsel") are often involved in the valuation aspects of taxation for their corporate, individual, and trust clients.

Trust and estate counsel may become involved in these valuation considerations for tax and other estate planning, tax return compliance, audit response, tax appeal, and tax litigation purposes. For all of these purposes, counsel may have to retain, instruct, work with, rely on, and defend a valuation specialist (hereinafter "specialist") who conducts the valuation of the client's private company, business ownership interests, illiquid securities, and intangible assets.

For purposes of this discussion, these various valuation analyses are referred to collectively as "business valuations."

In these instances, counsel may need to retain the services of a specialist who performs such business valuation analyses. Depending on the particular taxation issue, counsel may retain the specialist either as a consulting expert or as a testifying expert.

Counsel may look for a specialist who has specialized experience and expertise in:

1. valuing companies in the subject industry segment,
2. conducting analyses for the specific subject purpose (e.g., the business valuation of private ownership interests for transfer tax or income tax purposes)), and
3. if relevant, providing an expert report and providing testifying expert services at a deposition, administrative appeal hearing, and/or trial.

This discussion provides practical guidance to trust and estate counsel involved in such tax planning, compliance, appeal, or litigation matters with regard to selecting and working with such a business valuation specialist.

This discussion summarizes the typical development procedures and the typical reporting procedures related to the business valuation of the subject company business ownership interest securities, or intangible assets. And, this discussion summarizes the professional standards and the professional practices that such a specialist typically follows in the business valuation process.

In other words, this discussion summarizes what trust and estate counsel needs to know to retain and to work with a valuation specialist for tax planning, compliance, appeal, or litigation purposes.

The Business Valuation

For purposes of this discussion, the valuation subject in the taxation matter may include any private business, business ownership interest, security, or intangible asset.

Such a business interest could include a C corporation, S corporation, limited liability company ("LLC"), partnership, sole proprietorship, or any other tax or legal business form.

The business ownership interest could include the subject entity, a joint venture, a franchise agreement, or any other contractual agreement or contract right related to the subject entity. And, the ownership interest could include a fee simple interest (or total ownership interest) or a limited or partial ownership interest—such as a term interest or a reversionary interest.

The security could include common stock, preferred stock, a partnership interest, LLC member units, or other equity interest. The equity ownership interest could be controlling ownership interest or a noncontrolling ownership interest. The equity interests could enjoy voting rights—or not.

The equity interest could be marketable, nonmarketable, or subject to various types of contractual transferability restrictions. In fact, the equity interest could be subject to the terms of a shareholder agreement, partnership agreements LLC membership agreement, or other contractual agreement.

The security could also include secured and unsecured debt instruments. The security could include convertible debt instruments. And, the security could include options, warrants, grants, and other contract rights.

The intangible asset could include intellectual property, other identifiable intangible assets, intangible value in the nature of goodwill, or any type of license or contract rights or provisions related to such intangible assets.

And, any of these ownership interests could be included in a trust, a pension plan, or some other special ownership instrument or mechanism.

Any of the above intangible property interests may be the subject of a "business valuation" for transfer tax or income tax purposes.

There are generally accepted business and security valuation approaches and methods. And, there are generally accepted intangible asset valuation approaches and methods.

There are conceptual similarities between these two sets of valuation approaches and methods. With regard to the individual analytical procedures and individual valuation variables, there are subtle—but important—differences between these two sets of valuation approaches and methods.

The specialist's familiarity with business valuation—and with intangible asset valuation—approaches and methods is discussed below. Otherwise, a detailed discussion of these two sets of valuation approaches and methods is beyond the scope of this discussion.

Selecting the Valuation Specialist

Trust and estate counsel should exercise due diligence in selecting the specialist. Some of the counsel's selection criteria may include the following:

1. The institutional qualifications (including experience and expertise) of the specialist's firm
2. The professional qualifications (including experience and expertise) of the individual specialist
3. Any prior relationships of the specialist with the taxpayer (and/or the subject company)

Considerations regarding the Specialist's Firm

There are many types of professional service firms that provide valuation services, including public accounting firms, industry specialist consulting firms, valuation groups within general financial advisory services firms, business valuation firms, real estate and other property appraisal firms, forensic analysis firms, economic consulting firms, and many others.

Some of these firms are very small, including sole practitioners and small professional practices. Some of these firms are quite large, with dozens of offices and hundreds of practitioners.

Some firms specialize in the valuation analysis of (1) certain types of businesses (including industrial or commercial companies or professional services firms) or of (2) certain types of business ownership interests (including restricted public securities or intellectual property).

Some firms specialize in the analysis of certain industries or industry segments (including public utilities, regulated industry companies, energy companies, construction industry companies, transportation companies, health care companies, legal or accounting practices, engineering companies, etc.).

Some firms specialize in the development of business, security, and/or intangible asset valuations prepared for specific purposes (including valuations for financing, bankruptcy, gift and estate tax, income tax, property tax, financial accounting, condemnation and eminent domain, or other purposes).

Some firms specialize in controversy-related valuation analyses. These firms primarily specialize in providing valuation-related consulting expert services and testifying expert services. Such controversies could include tort disputes, breach of contract disputes, taxation matters, family law matters, eminent domain matters, and others.

In addition, some valuation firms are deliberately generalist firms. These firms perform both business and property valuations. These firms may practice across many industries and many industry segments. And, these firms may provide valuation services for transaction, financing, taxation, financial accounting, corporate planning, litigation, and many other purposes.

The institutional qualifications of each valuation firm can be demonstrated in different ways. Some counsel may prefer firms that specialize in conducting valuations for a specific purpose (e.g., transfer tax, income tax, property taxation). Other counsel may prefer firms that are more generalist in nature—that is, firms that do not focus exclusively on engagements for taxation or for any particular purpose.

Nonetheless, the selected firm should be able to demonstrate its professional experience related to:

1. conducting business valuation analyses for the subject transfer tax and income tax planning, compliance, appeal, or litigation purpose and
2. conducting business valuation analyses that can withstand a contrarian review (e.g., an Internal Revenue Service examiner's scrutiny, an Internal Revenue Service appeals division review, tax litigation cross examination).

Counsel may be particularly interested in the firm's valuation experience:

1. in the subject company's or the subject security's industry segment and
2. in the subject taxpayer's valuation issue (e.g., a charitable contribution of LLC membership interests or the gift of a nonmarketable, noncontrolling ownership interest in S corporation common stock).

Important Issues in the Valuation

There are relatively few areas that distinguish business valuations prepared for one purpose from business valuations prepared for another purpose. However, the selected valuation firm—and the selected valuation specialist—should be familiar with such differences.

For example, the following issues may be important in the business valuation prepared for transfer tax or income tax purposes:

1. The transfer tax and income tax valuation sometimes includes elements of both a business valuation and an intangible asset valuation (either separately or as a component of the business valuation). Accordingly, the specialist should be familiar with both generally accepted business valuation principles and generally accepted intangible asset valuation principles.
2. The specialist should be familiar with the professional standards and the professional practices related to both business valuation and intangible asset valuation.
3. Regardless of what business interests (business, business ownership interest, security, or intangible asset) are included in the transfer or other taxable transaction, only the property interests subject to taxation should be included in the valuation. So, the specialist has to be able to identify and to appraise only those value elements (e.g., including control elements, marketability elements, ownership rights, contractual provisions) that should be included in the taxable event.
4. The appropriate standard of value and the appropriate premise of value should be based on the purpose of the valuation analysis; that is, the valuation standard and the valuation premise should be appropriate to the tax-related statutory authority, administrative rulings, and judicial precedent. While some intercompany transfer pricing analyses should conclude the arm's-length

price standard, the appropriate valuation standard for most transfer tax and income tax valuations is fair market value.

5. The identification and the valuation of any business owner or personal intangible value in the nature of goodwill—as compared to business or institutional intangible value in the nature of goodwill—should be considered and, if appropriate, subtracted from the private company business value.
6. The measurement of (and the reasons for) any value appreciation (or value depreciation) between two dates (e.g., the entity purchase or creation date and the current transfer date) may be relevant.
7. The amount of (and the reason for) any extraordinary (i.e., above the industry average) appreciation in the private company, business ownership interest, security, or intangible asset value during a specific time period may be examined.
8. The valuation of the subject company on multiple dates (e.g., an event that could cause the recognition of a worthless stock deduction) may be considered.
9. The use of forensic accounting procedures—to identify unreported assets, unrecorded liabilities, and to conduct due diligence management interviews—may be appropriate.
10. The identification and quantification of any valuation adjustments (i.e., valuation discounts and premiums) related to lack of marketability, the lack of control, or the lack of voting rights or other ownership rights may be appropriate when capital market pricing data or other data are used to value the subject private company or security.
11. The identification and quantification of any buyer-specific synergistic or strategic value increments that may be considered when merger and acquisition transaction pricing data are applied to value the subject private company or security.
12. The identification and consideration of any company-specific, security-specific, or intangible-asset-specific risk premiums may be appropriate in the specialist's development of the business valuation yield capitalization rate or direct capitalization rate.

Considerations regarding the Valuation Specialist

The professional qualifications of the individual valuation specialist are also important. The specialist may provide consulting expert services to counsel. And, the specialist may also provide testifying expert services to counsel. In addition, the specialist may also provide audit support and other litigation support services.

Accordingly, the professional qualifications of the individual specialist should be able to:

1. impress an Internal Revenue Service examination agent, an Internal Revenue Service appeals division hearing officer, or a judicial finder of fact and
2. withstand a rigorous contrarian scrutiny (from, say, the Internal Revenue Service legal counsel).

While assessing the professional qualifications of the individual specialist, counsel may inquire about that specialist's personal experience in conducting valuations:

1. related to a transfer tax or an income-tax-related issue,
2. of the type of business ownership interest, security, or intangible asset owned by the taxpayer,
3. in the subject company's industry segment, and
4. within an audit, appeal, litigation, or other contrarian environment.

In terms of education, many specialists have formal education in finance, accounting, and/or economics. In the same respect, many (but not all) specialists hold one or more professional valuation credentials granted by a recognized valuation professional organization ("VPO").

There is no statutory, judicial, or regulatory requirement that a specialist hold any particular valuation-related professional credential. Many industry consultants, economists, college professors, forensic accountants, real estate appraisers, business valuation analysts, and other types of professionals provide valuation services—without having earned a valuation-related professional credential.

However, counsel should be aware that the subject taxation matter may require a "qualified appraiser" to perform a "qualified appraisal." That is, the selected specialist may need sufficient qualifications in order to be accepted as a "qualified appraiser." And, the specialist's work product may need to be accepted as a "qualified appraisal."

In addition, counsel should be aware that there are VPOs that offer valuation-related training, examination, credentialing, and continuing education programs. There are business valuation professional credentials, and there are property appraisal professional credentials. Both sets of professional credentials may be relevant to the subject taxation-related valuation assignment.

Some of these professional credentials—and the related VPOs—in the business valuation discipline include the following:

1. The accredited in business valuation ("ABV") credential is granted by the American Institute of Certified Public Accountants ("AICPA")
2. The accredited senior appraiser ("ASA") business valuation credential is granted by the American Society of Appraisers
3. The certified business appraiser ("CBA") credential was previously granted by the Institute of Business Appraisers ("IBA") (see explanation below)
4. The certified valuation specialist ("CVA") credential is granted by the National Association of Certified Valuators and Valuation specialists ("NACVA")

In 2008, the IBA merged into NACVA. While NACVA no longer grants the CBA credential to new candidates, it does support and maintain the CBA program for the current CBA credential holders.

Counsel—and the specialist—may need to rely on real property, personal property, and other property appraisers within the context of developing the business valuation. In addition, the subject private company may own excess, investment, or other nonoperating property that may best be appraised by a property appraiser.

Some of the professional credentials—and the related VPOs—in the property appraisal discipline include the following:

1. The Appraisal Institute grants the MAI credential and other real estate appraisal credentials
2. The American Society of Appraisers grants appraisal credentials in real estate appraisal, machinery and technical services appraisal, and other property appraisal disciplines

Each of these VPOs has developed its own set of requirements in order for a candidate to earn its professional credential. Generally, each of the VPO credentialing requirements include college education, a minimum amount of practical valuation experience, attendance at technical courses and specialized training programs, reviews of demonstration valuation reports, recommendations of current credentialed members, and the passing of a comprehensive technical examination.

In addition, each of the VPOs has ongoing ethical standards compliance requirements and continuing professional education requirements.

Counsel should consider that the subject tax-related valuation assignment may include elements of both business valuation and property appraisal. Therefore, counsel may need to retain both business valuation analysts and property appraisers as part of the valuation specialist team.

In addition to the above-mentioned VPO credentials, many business valuation specialists are either certified public accountants ("CPAs") or chartered financial analysts ("CFAs").

The CPA credential involves a uniform national examination and state-specific accountancy licensing requirements. Many CPAs are (but are not required to be) members of the AICPA. The CFA credential is granted by the Chartered Financial Analyst Institute ("CFAI").

Each of the business-valuation-related VPOs (i.e., AICPA, ASA, IBA, and NACVA) has promulgated its own set of professional standards. (In 2008, the IBA professional standards were conformed to—and then merged into—the NACVA professional standards.)

The most voluminous of the various set of business valuation professional standards is the AICPA *Statement on Standards for Valuation Services* ("SSVS"). The title of SSVS is Valuation of Businesses, Business Ownership Interests, Securities, and Intangible Assets.

Unrelated to any of the above-mentioned VPOs, the Appraisal Standards Board of the Appraisal Foundation promulgates the *Uniform Standards of Professional Appraisal Practice* ("USPAP").

The USPAP standards 1 and 2 relate to the development and the reporting (respectively) of real property appraisals.

The USPAP standards 3 and 4 relate to the development and the reporting of appraisal reviews.

The USPAP standards 5 and 6 relate to the development and the reporting (respectively) of mass appraisals.

The USPAP standards 7 and 8 relate to the development and the reporting (respectively) of personal property appraisals.

And, the USPAP standards 9 and 10 relate to the development of and the reporting of (respectively) a business valuation or an intangible asset valuation.

The subject business valuation may involve consideration of the value of all of the taxpayer's real property, tangible personal property, and intangible personal property. Therefore, the selected valuation specialist should be familiar with all of the above-listed components of USPAP.

Prior Relationship of the Valuation Specialist and the Taxpayer or the Subject Company

Counsel may also inquire about independence issues when retaining the valuation firm or the individual valuation specialist. There may be a concern if the valuation firm works regularly for the subject taxpayer or the subject company.

That association may present the appearance of a bias. That is, the selected specialist should be independent—and appear independent—with regard to the subject taxpayer and the subject company.

In addition, many valuations performed for financing, transaction, accounting, or litigation purposes require the specialist to be independent of the subject company. The appearance of independence could be questioned if the specialist is frequently retained by the subject taxpayer or by the subject company.

Reviewing the Valuation Report

The first step in counsel's review of—and dependence on—the specialist's valuation report is to become familiar with the business valuation process. Counsel should understand the level of due diligence and analysis that will be conducted by the specialist in order to reach the business valuation conclusion.

For example, counsel may be interested in whether the specialist plans to interview the private company management—or other parties—during the course of the business valuation. These interviews may be conducted in order to:

1. understand the nature and history of the subject company business operations and
2. discuss the historical and prospective performance (financial and operational) of the subject company business operations.

If all parties agree, counsel may arrange for these interviews to take place in person at the private company's facilities. This arrangement may provide the valuation specialist with the opportunity to tour the company's facilities and to view the physical condition of the company's tangible assets.

If the parties agree to the interviews, the interview process may also allow the specialist to gain a better understanding of the company's (1) services, (2) strategic plan, (3) competitors, and (4) competitive position in the market.

As mentioned above, there are generally accepted business valuation approaches and methods. The specialist typically considers each of these generally accepted business valuation approaches and methods:

Income approach

- Discounted cash flow method
- Direct capitalization method

Market approach

- Guideline publicly traded company method
- Guideline merger or acquisition transactions method
- Backsolve method

Asset-based approach

- Adjusted net asset value method
- Asset accumulation method

As mentioned above, there are also generally accepted intangible asset valuation approaches and methods. The specialist typically considers each of these generally accepted intangible asset valuation approaches and methods:

Income approach

- Multiperiod excess earnings method
- Capitalized excess earnings method
- Profit split (or residual profit split) method
- Incremental income method
- Differential income method

Market approach

- Sales comparison method
- Relief from royalty method
- Comparable profit margin method

Cost approach

- Trended historical cost less deprecation method
- Replacement cost new less deprecation method
- Reproduction cost new less deprecation method

The specialist will typically consider all business valuation methods and/or all intangible asset valuation methods. And, the specialist will typically apply:

1. each valuation method for which there is a sufficient quantity and quality of data and
2. each valuation method that is applicable to develop a credible valuation of the subject business, security, or intangible asset.

The specialist typically reconciles and synthesizes the value indications from each applicable method in order to conclude a final value opinion for the subject business, security, or intangible asset.

The business valuation analysis may be documented with a narrative valuation report. As stated above, each of the VPOs has issued professional standards with regard to valuation reporting. The following sections provide a summary of the typical contents of such a business valuation report.

Description of the Taxpayer's Subject Ownership Interest

The valuation report should adequately describe the ownership interest subject to valuation. Typically, this description typically includes the following:

1. The name of the subject company
2. The form of the subject entity legal ownership
3. The entity that owns the valuation subject (if the subject is an intangible asset or a subsidiary or other business unit of a parent corporation)
4. The types of securities included in the valuation analysis
5. The level of ownership interest (or the level of control, marketability, and other ownership interest elements)

For example, a description of the valuation subject may read as follows:

> We estimated the fair market value of 1,000 nonvoting membership units ("the subject units") of the Interstate Pipeline LLC ("IP"). IP is a wholly owned subsidiary of International Pipelines Corporation. We estimated the fair market value of the subject units on a nonmarketable, noncontrolling ownership interest basis.

The above description informs the valuation report reader as to:

1. the name of the company subject to the valuation,
2. the securities subject to valuation, and
3. the bundle of property rights included in the value conclusion.

Standard of Value and Premise of Value

The valuation report should describe the standard of value (or definition of value) that is concluded in the analysis. Most transfer tax and income-tax-related valuations typically apply the fair market value standard of value and a premise of value that concludes the highest and best use of the subject business, security, or intangible asset.

Generally, specialists apply the definition of fair market value that is included in Internal Revenue Service Revenue Ruling 59-60. Fair market value is generally defined to be the price at which the property would change hands between a willing buyer and a willing seller, when neither is under any compulsion to buy or to sell, and with both parties having reasonable knowledge of the relevant facts.

Some specialists expand this definition to add that the buyers and sellers are hypothetical buyers and sellers—as opposed to a specific buyer and/or seller. Nevertheless, the important elements of the definition remain the same. That is, an unrelated buyer and seller are coming together to conduct a transaction when neither is being forced to buy or sell and both parties are aware of all relevant information concerning the subject ownership interest.

The valuation report should also describe the premise of value—that is, the valuation report should explain whether the valuation subject was valued based on the premise of:

1. value in use—as part of a going-concern premise of value—or
2. value in exchange—as part of an orderly disposition of individual assets premise of value.

If the valuation specialist did not value the subject business interest based on the premise of value in use as a going concern, then the valuation report should discuss the rationale for conducting the valuation based on an alternative premise of value.

Purpose of the Analysis

The valuation report should describe the purpose of the analysis. Typically, the purpose of the valuation report is to provide information to the parties involved in the subject transfer tax or income tax matter.

The valuation report should describe the purpose of the analysis so there is no confusion over the intended use of the report.

Valuation Date and Report Date

The valuation report should indicate (1) the valuation date and (2) the report date. The valuation date is the "as of" date on which the specialist's value opinion applies. The report date is the date on which the specialist's valuation report was signed and issued.

For example, the valuation report may estimate the fair market value of the total common equity of Illustrative Company as of January 1, 2020. However, the valuation report may not be prepared until April 15, 2020. In this case, the valuation date is January 1, 2020, and the report date is April 15, 2020.

In this example, counsel should understand that the valuation opinion takes into account all known and knowable information available through January 1, 2020. Under the fair market value standard of value, the valuation report typically does not consider any information that became available, or known, subsequent to the valuation date.

Level of Value and Prerogatives of Ownership Control

In a business valuation, the specialist typically (but not always) concludes a fee simple ownership interest in the subject company securities, or intangible asset. If the valuation subject is something other than a fee simple ownership interest, that fact should be clearly disclosed.

The specialist needs to consider the control elements associated with the valuation subject. That is, the specialist either values the subject interest on a controlling ownership interest basis or a noncontrolling ownership interest basis.

Likewise, the specialist needs to consider the marketability elements associated with the valuation subject. That is, the specialist either values the subject ownership interest on a marketable interest basis or on a nonmarketable interest basis.

The valuation report typically identifies the subject property and describes the prerogatives of ownership control and the marketability (or lack thereof) characterizations that accompany the ownership interest.

The valuation report will often:

1. identify the specific control attributes and marketability attributes associated with the subject business, security, or intangible asset and
2. explain how these control attributes and marketability attributes were considered in the business valuation process.

Sources of Information

The business valuation report typically includes a section that lists the data and the documents that the specialist relied on to develop the value opinion.

By reviewing this section of the valuation report, counsel should develop an understanding of both (1) the publicly available documents and (2) the non-publicly-available documents that the specialist considered in the valuation process.

The sources of information list should include the financial-related documents used in the valuation analysis (e.g., financial statements, empirical market data), and the non-financial-related documents (e.g., client or supplier contracts, leases, licenses, corporation documents).

The sources of information list should enable the report reader to identify the documents necessary to replicate the valuation analysis.

Description of the Subject Company

The valuation report should provide an adequate description for the reader to understand the fundamental position of the subject company, or security, or intangible asset.

The valuation description of the subject company subject or of the subject intangible asset typically includes the following:

- A discussion of the history of the subject company and its current position
- A description of the goods or services provided by the subject company
- A description of the markets served by the subject company
- A description of the competitive environment in which the subject company operates and how the company is positioned within that competitive environment (i.e., the company's market position)
- A discussion of the principal facilities or other properties owned or operated by the company
- A discussion of the company's significant relationships with related parties, clients, suppliers, and so on
- A discussion of any pending litigation or regulatory issues that are significant to the company
- A review of recent transactions (if any) in the company or its securities or its intangible assets
- A discussion of any recent offers received for the company, or its securities or its intangible assets

Overview of General Economic Conditions and Industry Conditions

The valuation report should provide the reader with an overview of the general economic conditions and industry-specific factors that affect the valuation of the subject company.

The economic overview may include a discussion of trends in economic growth, inflation, consumer spending, consumer confidence, interest rates, construction starts, and business spending. In each case, the analysis should be tailored to the economic factors that most directly affect the subject company. This valuation report section may also include a discussion of economic indicators that provide insight into the future performance of the subject company.

The industry overview report section typically describes:

1. how the company's industry operates and
2. recent trends affecting companies within the company's industry segment.

This report section may also describe:

1. the subject company's position in its industry segment and
2. the subject company's market share relative to other competing companies.

Subject Company Financial Performance

As part of the valuation process, the specialist assesses the financial performance and financial condition of the subject company. A summary of this financial analysis typically appears in the valuation report.

The subject company's historical financial performance is reflected on the company's income statements and cash flow statements. The valuation report may include a discussion of the following:

- The historical growth or decline in revenue
- The historical growth or decrease in aggregate profitability (i.e., gross profit, operating profit, pretax profit, and net profit)
- The historical growth or decrease in profit margins
- The historical growth or decrease in cash flow
- The historical payments of dividends

The specialist also reviews the company's balance sheet to assess the company's financial condition. The valuation report may contain a discussion of the following balance-sheet-related items:

- The company's liquidity and working capital position
- The company's asset utilization by means of various financial or operational ratios (e.g., accounts receivable turnover, inventory turnover, etc.)
- The company's tangible property base
- The company's capital structure and leverage
- The net book value of the company (as required in Revenue Ruling 59-60)

This financial analysis may include a discussion of significant financial statement trends and a discussion of what factors caused the respective trends.

The valuation report may also include a discussion of how the subject company performs relative to other companies in the company's industry segment. This comparative financial analysis typically identifies the financial strengths and weaknesses of the company compared to other guideline/competing companies.

The comparative financial analysis should help the report reader to understand how the subject company performs relative to other companies in the industry segment. This comparative performance analysis may be based on such factors as size, growth, profitability, and volatility.

Financial Statement Normalization Adjustments

When appropriate, the specialist may make normalization adjustments (1) to the subject company's financial statements and (2) to selected guideline publicly traded companies' financial statements.

The financial statement normalization adjustments may be necessary in order to present the financial performance of the subject company on the same basis as the financial performance of the selected guideline companies.

The following list includes some of the financial statement adjustments that the specialist may consider:

- Adjustments for extraordinary or nonrecurring income and expense items
- Adjustments for differences in inventory (and other) accounting methods
- Adjustments for nonoperating income and expense items
- Adjustments for non-arm's-length transactions/arrangements
- Adjustments for excess compensation or other benefit expense

The valuation report should identify any financial statement adjustments and explain the rationale for each adjustment.

Generally Accepted Valuation Approaches and Methods

As mentioned above, there are three generally accepted business valuation approaches: the market approach, the income approach, and the asset-based approach.

And, there are three generally accepted intangible asset valuation approaches: the market approach, the income approach, and the cost approach.

A detailed discussion of the generally accepted valuation approaches is beyond the scope of this discussion.

The valuation report should describe which business or intangible asset valuation approaches—and which valuation methods within each approach—the specialist applied in the valuation analysis. In the same respect, the valuation report should explain which business or intangible asset valuation approaches were not applied in the valuation analysis—and why the specialist did not apply them.

With regard to the business valuation market approach, and specifically the guideline publicly traded company method and the guideline merger and acquisition ("M&A") transactions method, the valuation report should include the following:

- The criteria the specialist applied to select the guideline public companies and the guideline M&A transactions. The selection criteria may include standard industrial classification code, business description, location, size, growth rate, profitability metrics, return on investment metrics, or a combination of several relevant factors.
- A description of each selected guideline publicly traded company and guideline M&A transaction. This description may include a discussion of each selected guideline company's (or guideline transactions) business, its location, its products and/or services, and its position in the market.

  Other information, such as whether the guideline publicly traded company recently completed acquisitions, may also be relevant.
- The market-derived pricing multiples that the specialist selected for the business valuation. These pricing multiples may include invested capital (i.e., total long-term debt plus total equity) pricing multiples, equity pricing multiples, or asset pricing multiples. Industry-specific factors often influence the type of market pricing multiples that the specialist applies in the valuation analysis.

  For example, the valuation of an electric generation company may involve the application of market-derived pricing multiples that are based on (1) the company's revenue generation, (2) the company's electric generation capacity, or (3) the company's average actual electric generation during a recent time period.

In contrast, the valuation of a hospital or nursing home company may involve the application of market-derived pricing multiples that are based on (1) the number of licensed beds in the facility or (2) the average actual utilization (occupancy) of the number of licensed beds during a recent time period.

As a further example, the valuation of a railroad or an airline may involve the application of market-derived pricing multiples that are based on (1) revenue generation; (2) earnings before interest, taxes, depreciation, and amortization (or EBITDA); or (3) net cash flow.

- The rationale for selecting the market-derived invested capital pricing multiples that the specialist applied to the subject company's financial fundamentals. The valuation report reader should be able to understand the specialist's thought process for arriving at the selected valuation pricing multiples.

  The application of an average or a median market-derived pricing multiple, with no support for such a selection, is typically not appropriate.

  Rather, subject-specific pricing multiples are typically based on the specialist's comparison of the subject company to the market-derived guideline companies or to the guideline transactions in terms of (1) size, (2) growth rates, (3) profit margins, and (4) returns on investment.

- The rationale for the selected weighting the specialist applied in the valuation synthesis.

  For example, if the business value indication based on a multiple of projected net cash flow is assigned more (or less) weight than the business value indication based on a multiple of trailing 12-month net cash flow, then the valuation report should explain why the specialist assigned that relative weighting.

With regard to the business valuation income approach, and specifically the discounted cash flow method, the valuation report should include the following:

- A discussion of who prepared the financial projections that are incorporated in the unit valuation. The financial projections are often prepared by the subject company management. In other cases, the financial projections may be prepared by the specialist with input from the subject company management.

  In the case of management-prepared financial projections, the valuation report may explain how the specialist tested the reasonableness of these financial projections. In all cases, the company's financial projections relied on in the valuation income approach analysis should be supported and supportable.

- A discussion of the appropriate matching of the financial projections and the present value discount rate. For example, if the discounted cash flow method incorporates a projection of net cash flow to invested capital (i.e., to the subject company's total long-term debt plus total equity), then the present value discount rate should be the weighted average cost of capital.

  If the cash flow projection is developed on a pretax basis, then the applicable present value discount rate should be developed on a pretax basis. If the cash flow projection is developed on an after-tax basis, then the applicable present value discount rate should be developed on an after-tax basis.

  That is, both the income projection and the present value discount rate (or the direct capitalization rate) should be developed based on the same:

  1. level of ownership interest (e.g., total equity versus total invested capital) considered in the analysis and
  2. level of income taxation applied in the analysis.

- A discussion of the cost of capital components. This discussion may include an explanation of how the specialist estimated the cost of equity capital, the cost of debt capital, and the weighting of each of the capital components in the weighted average cost of capital calculation.

- Support for any selected residual value (also sometimes called terminal value) pricing multiple or residual value direct capitalization rate. In many business valuations, the residual value may represent a significant portion of the total business value.

  As a result, the selected residual value pricing multiple, or the residual value direct capitalization rate, often has a material effect on the business value conclusion. The specialist's rationale for the selected residual value pricing multiple, or the selected long-term growth rate component of the residual value direct capitalization rate, should be adequately explained and supported in the valuation report.

For an intangible asset valuation, the generally accepted cost approach valuation methods include the trended historical cost less depreciation ("THCLD") method, the replacement cost new less depreciation ("RCNLD") method, and the reproduction cost new less depreciation ("RPCNLD") method.

All of these cost approach methods have two elements in common:

1. They apply a comprehensive definition of cost—that is, the selected cost metric includes all applicable cost components.
2. They include a comprehensive definition of depreciation—that is, the depreciation metric includes all depreciation and obsolescence components.

Counsel (and the specialist) should also be aware that it is possible to apply the cost approach to value all of the subject company's asset categories, including the following:

1. Working capital accounts
2. Real estate
3. Tangible personal property
4. Intangible personal property
5. Intangible value in the nature of goodwill

Counsel (and the specialist) should be aware that the cost approach depreciation analysis should include all types of property depreciation categories:

1. Physical depreciation
2. Functional obsolescence
3. Economic obsolescence

Financial accounting (or "book") depreciation typically encompasses the following:

1. Physical depreciation
2. Some components of functional obsolescence

Financial accounting depreciation does not include:

1. all components of functional obsolescence or
2. any economic obsolescence.

These depreciation components should have been separately identified and separately measured in the application of the cost approach in a tangible asset valuation.

Counsel (and the specialist) should be aware that the cost approach may be applied to estimate the going-concern value of the assets—tangible and intangible—of the subject company.

That is, the cost approach (unless specifically applied to conclude such a value) does not conclude the liquidation value of the assets—tangible and intangible—of the going-concern subject company. Rather, the cost approach typically concludes the going-concern value of the subject company's property categories.

Valuation Synthesis and Conclusion

The valuation report should contain a section that provides the following:

1. A valuation synthesis of the alternative unit value indications
2. A final value conclusion for the subject business, business ownership interest, security, or intangible asset

The following factors are typically included in this valuation report section:

- A discussion of how each value indication from each valuation approach and method was weighted in the final value conclusion. An explanation should be provided for each of the selected value indication weightings.
- A discussion of any valuation adjustments—i.e., valuation premiums or discounts—that may be appropriate to reflect the elements of ownership control and marketability

related to the subject business ownership interest or security.

The discussion of the application of valuation adjustments may include:

1. the specialist's rationale for any valuation premium or valuation discount applied and
2. the supporting data or factors that the specialist considered in order to select any applicable valuation premium or valuation discount.

The valuation report should explain how the specialist reconciled and synthesized each value indication in order to reach a final value conclusion. The valuation report should provide sufficient information to allow the report reader—and the counsel—to recreate the specialist's thought process and to replicate the specialist's mathematical procedure to reach the final value conclusion.

After reviewing the valuation report, the counsel—or any other report reader—should be able to understand the following issues:

- Was the valuation report readable and easy to understand? Or, was it filled with undefined valuation terms and jargon?
- Was the valuation report comprehensive and organized in a logical manner?
- If more than one valuation date is considered, has the concluded value changed over time, and if so, what were the primary drivers of this change in value (i.e., the subject company's performance, the subject industry or market condition performance, or a combination of the two)?
- Has the subject company's financial performance improved or deteriorated over time, and has the concluded value changed accordingly?
- Which generally accepted business or intangible asset principle valuation approaches and methods were applied in the analysis? And, why were they applied?
- Does the value conclusion seem reasonable given (1) the historical and projected financial performance of the subject company, (2) the relevant market-based data, and (3) the relevant general economic conditions and industry-specific conditions?
- Does the value conclusion appropriately reflect the relevant standard of value, premise of value, and other property-specific factors and/or legal instructions?

Summary and Conclusion

Trust and estate counsel are often involved with the valuation aspects of transfer tax and income tax. These issues may involve tax planning, compliance, appeal, or litigation. In such taxation matters, counsel often have to retain, instruct, work with, rely on, and defend a valuation specialist.

"The valuation report should provide sufficient information to allow the report reader . . . to recreate the specialist's thought process and to replicate the specialist's mathematical procedure to reach the final value conclusion."

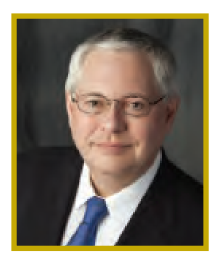
In such instances, counsel have to select a specialist with the appropriate credentials, experience, and expertise to value the subject business, business ownership interest, security, or intangible asset.

This discussion summarized some of the issues that trust and estate counsel may consider in the selection of such a specialist. Such a specialist may assist the tax counsel as a consulting expert or as a testifying expert.

In addition, this discussion summarized the development procedures and the reporting procedures related to the tax-related valuation of the subject business, business ownership interest, security, or intangible asset.

Trust and estate counsel should be generally aware of the professional standards and the professional practices related to the development of—and the reporting of—the business or intangible asset valuation. This is because, in addition to retaining the valuation specialist, counsel may have to work with, rely on, and defend the selected specialist during the tax audit, appeals division conference, or litigation.

This discussion summarized what trust and estate counsel need to know about working with a valuation specialist in the development of, and the defense of, a business valuation or intangible asset valuation for transfer tax or income tax purposes.



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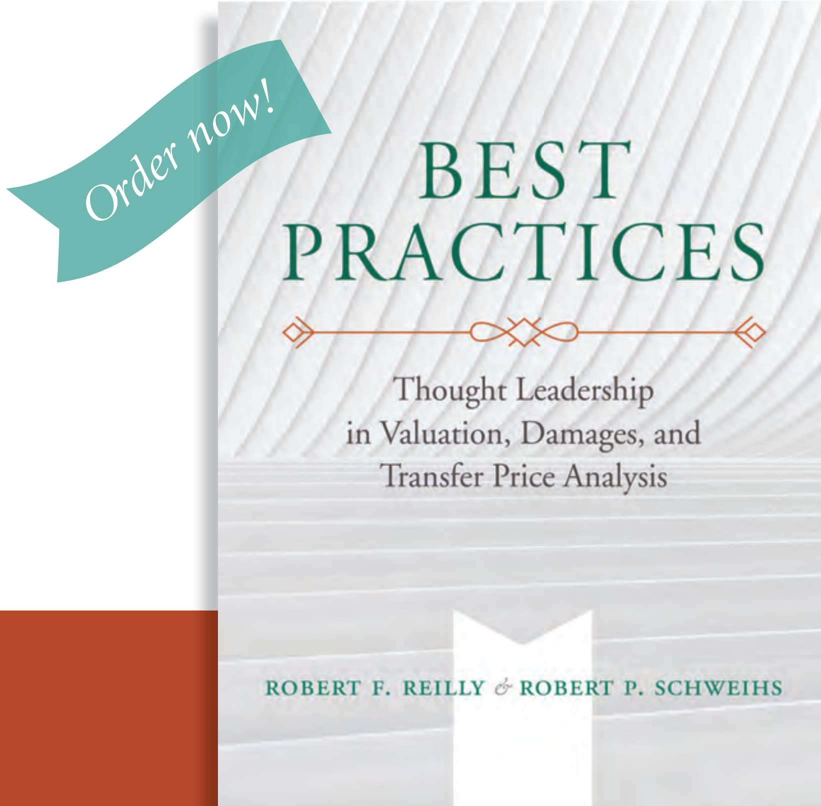
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Compensating Private Company Key Employees with Stock-Based Compensation Grants

Michael L. Binz and Robert F. Reilly, CPA

Many private companies use stock-based compensation arrangements to recruit and retain qualified employees, particularly at the experienced hire and management levels. This discussion summarizes the various types of stock-based compensation plans available to the private company to attract and retain key employees. In particular, this discussion focuses on the income tax considerations (to both the employer company and to the key employee) related to such stock-based compensation arrangements.

Introduction

Private companies in most industries have to compete with public corporations to attract and retain experienced employees. At these private companies, there is often competition for experienced hires, particularly at the management level. To both attract and retain key employees, many private companies use stock-based compensation grants as a component of their portfolio of employee compensation arrangements.

However, there are various income tax considerations related to stock-based employee compensation awards. These income tax considerations related to stock-based employee compensation grants affect both (1) the private company (i.e., the award grantor) and (2) the individual employee (i.e., the award grantee).

This discussion summarizes some of the basic—but important—income tax considerations with regard to the compensatory transfer of employer corporation stock. This discussion summarizes both the employer's—and the employee's—federal income tax considerations related to stock-based compensation.

Stock-Based Compensation Programs

For most companies, including private companies, the typical types of employee stock-based compensation awards include the following:

1. Restricted stock awards ("RSAs")
2. Restricted stock units ("RSUs")
3. Nonqualified stock options ("NSOs")
4. Incentive stock options ("ISOs")

Each of these different types of employee stock-based awards is summarized below.

From the perspective of both the employer and the employee, each of these different types of stock-based compensation programs has both advantages and disadvantages.

The consideration of both the advantages and the disadvantages is particularly relevant with regard to income tax issues. Therefore, both the private company employer and the key employee should carefully consider the pros and cons of such compensation programs.

Exhibit 1 to this discussion, which begins on page 85, summarizes the income tax consequences—primarily from the employer company's perspective—of each of the above-listed types of stock-based compensation arrangements.

Restricted Stock Awards

RSAs are actual shares of the employer corporation stock that the private company transfers to the key employee. Typically, the transfer is made at no cost to the employee. Such transfers are typically made subject to a multiple-year vesting schedule.

When the stock transfer vests, the fair market value of the private company stock is deductible to the employer corporation—on that vesting date. On that same vesting date, the fair market value of the private company stock is reported as W-2 wages to the key employee.

Typically, the employer has to withhold from the employee/recipient's other taxable income both:

1. applicable federal, state, and local income taxes and
2. Federal Insurance Contributions Act ("FICA") taxes.

However, there are some other withholding options that may be considered. For example, to cover the amount of the tax withholding, the employee/recipient may remit cash back to the employer company.

Alternatively, the employer company may withhold some of the newly issued shares of stock with a fair market value equal to the amount of the tax withholding liability.

Often, the key employee may make an Internal Revenue Code ("Code") Section 83(b) election related to the RSA. If the employee makes the Section 83(b) election within 30 days of the RSA grant, then the employee will recognize taxable income immediately on the grant date. That is, the employee does not wait until the vesting period expires—and until the employer company stock fair market value has increased—to recognize the taxable income.

Such a Section 83(b) election may be attractive to the key employee when that employee believes that the private company stock value will increase during the award vesting period.

The Section 83(b) election is an alternative option. This is because such an election would:

1. minimize the employee's ordinary income during the vesting period and
2. maximize the employee's capital gain when the employer company stock is ultimately sold.

However, the key employee should carefully consider the Section 83(b) election. This is because, if the stock grant does not vest or the value of the employer company stock decreases over time, then the employee cannot obtain a refund of the income taxes paid at the time of the original election.

Restricted Stock Units

An RSU is a promise made by the employer company to deliver the private company stock (or cash) to the key employee at some time in the future. The amount of private company stock delivered is based on the stock's performance (i.e., value).

Since an RSU is not considered to be property for income tax purposes, it is not governed by Section 83. Accordingly, there are no income tax implications when an employer company grants an RSU to a key employee.

"An ISO award is typically preferred by the employee when the long-term capital gain tax rate is lower than the ordinary income tax rate."

The grant of an RSU is considered to be deferred compensation, taxed under Section 451. An RSU is also potentially subject to penalties under Section 409A. Under Section 451, the employer company is allowed a compensation tax deduction when the RSU is actually or constructively paid to the employee.

The amount of the employer company tax deduction is equal to the amount of compensation income recognized by the employee. Typically, this amount is reported to the Service on the employee's Form W-2 wage and tax statement.

The employer company is required to withhold applicable federal, state, and local income taxes from the RSU payout to the key employee.

Unlike an RSA, an RSU is subject to the Section 312(v)(2) special timing rules for FICA taxes on deferred compensation. If the employer's RSU program permits, the employer company may defer delivering the RSU payment to the key employee until a date after the vesting date.

This RSU payout can either be in shares of private company stock or in cash. The key employee may need to make a timely election in order to defer the receipt of the RSU payout.

Both the employer portion and the employee portion of the FICA tax is typically due when the RSU vests. The FICA tax payment is due even if the RSU payment does not occur until a later tax year.

Incentive Stock Options

An ISO award is typically preferred by the employee when the long-term capital gain tax rate is lower than the ordinary income tax rate. This employee preference is due to the following:

1. No taxable compensation is recognized when the ISO shares are transferred to the employee.
2. 100 percent of any appreciation in the private company shares is taxed to the employee as a capital gain—when the employee ultimately sells the shares.

In order for the key employee to receive this favorable income tax treatment, both the employer company and the employee have to satisfy the numerous requirements included in Sections 421, 422, and 424 (and the related regulations).

In order for the grant to qualify as an ISO, these requirements include (but are not limited to) the following:

1. The option price must be at least equal to the fair market value of the private company shares as of the date of grant.
2. The option must be issued pursuant to a written plan—and that plan must be approved by the private company shareholders within 12 months before or after the date that the plan is adopted.
3. The grants are only made to company employees, and the grants are nontransferable.
4. The option plan term may not exceed 10 years, and the employees must exercise the option within 10 years of the date of grant.
5. The total fair market value of the stock options that first became exercisable is limited to $100,000 in any one calendar year.
6. The employee may not dispose of the ISO shares any sooner than (a) two years after the grant date and (b) one year after the exercise date.

If all of these ISO requirements are satisfied, then the employer company will never be allowed an income tax deduction for the ISO stock compensation. Alternatively, if any of the ISO requirements are not satisfied, then the ISO is treated as a nonqualified stock option ("NQSO").

Upon a "disqualifying disposition" of an ISO, the following amount will be recognized as compensation income to the employee: (1) the disposition proceeds—up to the amount of the fair market value of the shares or the exercise date—less (2) the exercise price of the ISO paid by the employee.

The proceeds of the disqualifying disposition in excess of the fair market value of the shares on the exercise date will be taxed to the employee. This amount is taxed as either a long-term gain or a short-term gain, depending on the length of time that the shares are held by the employee after the exercise.

The employer company is entitled to an income tax deduction after a disqualifying disposition. The amount of the employer's tax declaration is equal to the amount of taxable compensation reported on the employee's Form W-2. That is, the employer's tax deduction is contingent on the W-2 reporting of the employee's taxable income.

According to Section 421(b), employer companies are not required to withhold income taxes on the amount of the taxable compensation caused by the disqualifying disposition of stock that the employee acquired from the exercise of the ISO.

Nonqualified Stock Options

An NQSO is a stock option that does not qualify as an ISO. Generally, the income tax treatment of an NQSO is governed by Section 83 (unless Section 409A applies).

To avoid the application of Section 409A, the private company should set the stock option exercise price equal to or greater than the share's fair market value on the grant date. A compensatory NQSO typically does not have a readily determinable fair market value on the grant date.

Therefore, for income tax purposes, an NQSO is typically not considered to be property on the grant date. Accordingly, an NQSO is typically not eligible for the Section 83(b) election.

The taxable event is considered to occur when the key employee exercises the NQSO. However, there is a special tax rule that would allow the employee to delay the taxable event beyond the exercise date.

The taxable event is considered to occur when the substantial risk of forfeiture lapses—that is:

1. the stock acquired upon the NQSO exercise is no longer subject to a substantial risk of forfeiture and
2. the Section 83(b) election is not made with respect to that stock.

That is, the stock must be subject to a vesting period. In that case, the taxable event occurs when the stock vests.

If the taxable event occurs on the exercise of the NQSO, then the employer company is allowed an ordinary income tax deduction. That tax deduction is equal to the amount of ordinary income recognized by the key employee on the spread between:

1. the fair market value of the stock and
2. the stock option exercise price.

The employer company is also required to withhold:

1. the applicable federal, state, and local income taxes and
2. the FICA tax—both related to the amount of compensation.

The employer company also has to pay the employer company portion of the FICA tax.

The taxable event typically occurs when the stock received from the exercise of the NQSO vests. In that case, the employer company is allowed an ordinary income tax deduction equal to the amount of taxable income recognized by the employee. That amount is based on the spread between (1) the fair market value of the stock on the vesting date and (2) the stock option exercise price.

The employer company is also required to withhold:

1. the applicable federal, state, and local income taxes and
2. the FICA tax—both related to the amount of the compensation.

The employer company also has to pay the employer's portion of the FICA tax.

"When considering what type of stock-based compensation award alternative to offer, the private company owner/operator should carefully consider the income tax consequences to both the employer company and the key employee."

An Opportunity to Defer the Payment of Taxes

The Tax Cuts and Jobs Act (P.L. 115-97) included a new Section 83(i), related to private companies. Section 83(i) allows employees of certain private companies to elect to defer the payment of income taxes on certain equity compensation for up to five years.

The amount of the income tax owed by the employee is still calculated based on the taxable event and the amount of compensation as described above.

However, the payment of the income tax from the employee to the Service is deferred because of the Section 83(i) election.

Of course, the delayed tax payment by the employee will also delay the employer company's income tax deduction—until the year when the employee actually pays the income tax liability.

Plans of qualifying employer companies are not automatically subject to the Section 83(i) income tax deferral rules.

Equity Grants May Be Made to Independent Contractors

So far, this discussion focused on the income tax consequences of compensatory stock awards to the private company's key employees. The private company may also want to make such compensatory equity awards to its independent contractors.

Other than an ISO, all of the above-mentioned types of equity grants are also available for award to independent contractors. Instead of reporting on a Form W-2, the tax reporting for independent contractors should be made on Form 1099 MISC, miscellaneous income.

Summary and Conclusion

Even in times of economic recession, there is often competition among private companies to attract and retain key employees (and especially experienced executives). Accordingly, many private companies in many industries compensate their key employees through the grant of company stock.

Employer companies have several different types of compensatory stock-based award programs available to them. Each of these types of compensatory stock-based arrangements has advantages and disadvantages—both to the employer and to the employee.

This discussion summarized the income tax consequences of four stock-based compensation award arrangements that a private company may provide to its key employees.

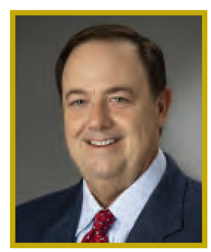
These four types of stock-based compensation arrangements are the following:

1. Restricted stock awards
2. Restricted stock units
3. Nonqualified stock options
4. Incentive stock options

Each of these four types of stock-based compensation programs has the same fundamental objective: to provide an incentive level of compensation to attract and/or retain key employees in the private company.

However, as indicated in Exhibit 1, each of these types of stock-based compensation arrangements has its own income tax consequences—both for the employer and for the employee.

When considering what type of stock-based compensation award alternative to offer, the private company owner/operator should carefully consider the income tax consequences to both the employer company and the key employee.



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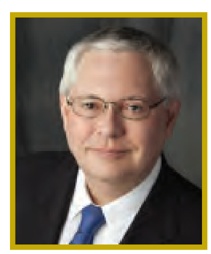

Exhibit 1
Private Company Stock-Based Compensation Arrangements
Federal Income Tax Consequences

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Stock purchase price to the employee	Typically no payment—but a payment is not prohibited.	Typically no payment—but a payment is not prohibited.	Typically no payment—but a payment is not prohibited.	Typically no payment—but a payment is not prohibited.
Award exercise price	NA`	NA	Must be no less than the employer company stock FMV on the grant date in order to avoid Section 409A issues; the exercise price can exceed the employer stock FMV.	Must be at least equal to the employer company stock FMV on the grant date—and at least 110% of the employer company stock FMV if the stock is granted to a 10% shareholder.
Employer company taxation on the grant date	No tax deduction allowed until the shares vest, unless the employee makes a Section 83(b) election. In that case, the employer company tax deduction is equal to the FMV of the transferred shares.	No tax deduction allowed if the grant complies with Section 409A. However, if Section 409A is violated, then the FMV of the benefits that are vested as of the employer company tax year-end, less amounts previously taxed, is tax deductible.	No tax deduction allowed if the NQSO exercise price is not less than the employer stock FMV on the grant date. However, if the exercise price is less than the employer company stock FMV on the grant date, then Section 409A applies. In that case, the FMV of the benefits that are vested as of the employer company tax year-end, less amounts previously taxed, is tax deductible.	No tax deduction is allowed to the employer company.
Grant vesting date	The tax deduction equals the FMV of the property transferred if no Section 83(b) election is made. However, no tax deduction is allowed if the grant was previously deducted when the Section 83(b) election was made.	No tax deduction allowed to the employer company.	The tax deduction is equal to the then-current FMV of the stock, less the exercise price paid, if (1) the vesting date of the employer company stock acquired upon exercise is later than the exercise date and (2) a Section 83(b) election was not made at the time of the grant exercise.	No tax deduction is allowed to the employer company.

Exhibit 1 (continued)
Private Company Stock-Based Compensation Arrangements
Federal Income Tax Consequences

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Grant exercise date	NA	NA	The tax deduction is equal to the then-current FMV of the stock, less the exercise price paid, if the exercise date is the vesting date for the employer company stock received in the exercise.	No tax deduction is allowed to the employer company.
Stock disposition date	No tax deduction allowed to the employer company.	No tax deduction allowed to the employer company.	No tax deduction allowed to the employer company.	No tax deduction allowed if the employee holds the stock for at least (1) one year after the exercise date and (2) two years after the grant date. If the holding period is not satisfied, then the tax deduction is equal to (1) the lesser of the stock FMV on the exercise date or the amount of the disposition proceeds, minus (2) the exercise price paid.
Stock dividends/ dividend equivalents	If dividends are paid to the holder of an unvested RSA, then the payment is deductible to the employer company as employee compensation—instead of being treated as a "true" dividend.	If rights under the RSU are increased due to the dividends paid before the RSU settlement, then the increase is deductible to the employer company upon payout as employee compensation, instead of being treated as a "true dividend.	Dividends are not typically paid to holders of unexercised stock options. However, if dividend equivalents are paid on the unexercised stock options, then the amount will not be treated as a dividend but would be deductible to the employer company as employee compensation.	Dividends are not typically paid to holders of unexercised stock options. However, if dividend equivalents are paid on unexercised stock options, then the amount will not be treated as a dividend but would be deductible to the employer as employee company compensation.

Exhibit 1 (continued)
Private Company Stock-Based Compensation Arrangements
Federal Income Tax Consequences

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Payroll tax withholding (state and federal income taxes and FICA)	Withholding from the employee compensation is required on the vesting date.	Income tax withholding is required when the amounts are paid to the employee. FICA tax withholding is required when the amounts are vested.	Income tax and FICA tax withholding from employee compensation is required on the exercise date if (1) it is the same date as the vesting date or (2) a Section 83(b) election was made. Payroll tax withholding is required on the vesting date if (1) the vesting date is later than the exercise date and (2) a Section 83(b) election was not made.	Income tax withholding, but not FICA tax withholding, is required on the employee compensation from a disqualifying disposition. Otherwise, no tax withholding is required.
Section 83(b) election (opportunity for the employee to pay the income tax early)	Available	NA	Available for the stock acquired upon exercise that is subject to a substantial risk of forfeiture (such as vesting).	NA
Section 83(i) election (opportunity for certain employees to defer the income tax payment)	NA	Certain employers can design a stock plan to allow an employee to defer the income tax payment, which will delay the employer company's income tax deduction.	Certain employers can design a stock plan to allow the employee to defer the income tax payment, which will delay the employer company's income tax deduction.	NA

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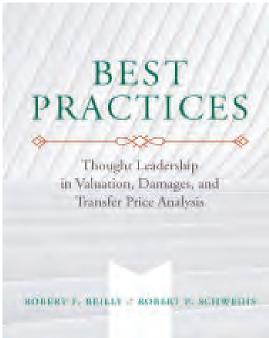

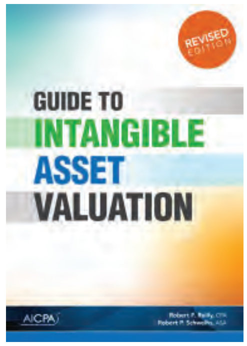

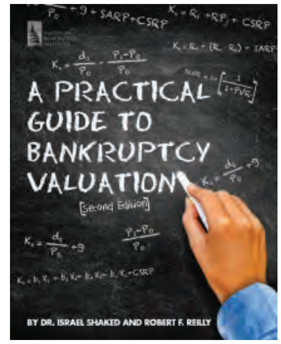

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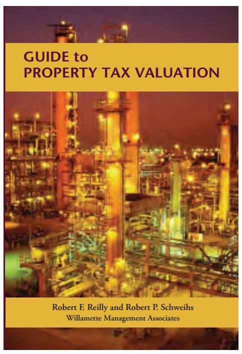

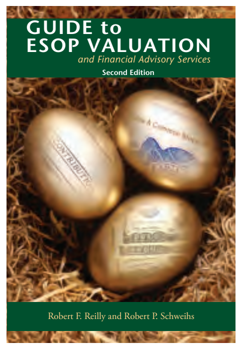

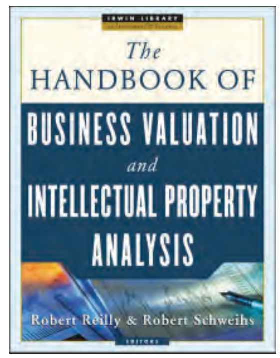

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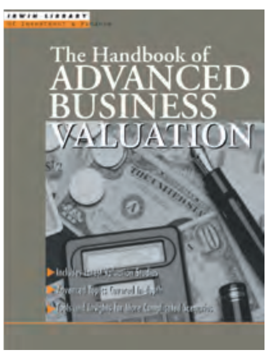

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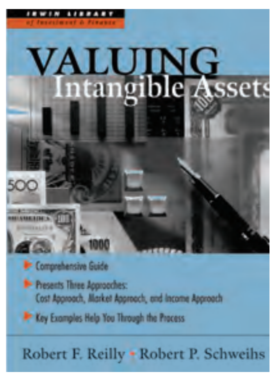

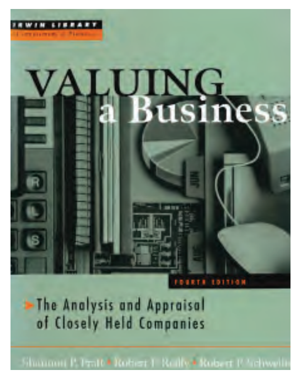

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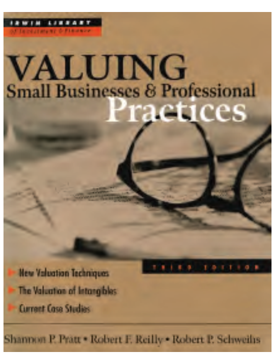
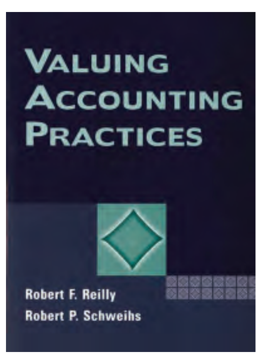




* Authored by Robert Reilly and Israel Shaked, Ph.D.
** Authored with Shannon Pratt
*** Edited by Robert Reilly and Robert Schweihs

Willamette Management Associates

Pierson M. Grieve v. Commissioner: Tax Court Rejects Theoretical Valuation Methodology

Chad M. Kirkland

This discussion considers the recent decision issued by the U.S. Tax Court in Pierson M. Grieve v. Commissioner of Internal Revenue. *Specifically, this discussion describes (1) the main topics of this judicial decision, (2) the valuation issues of this judicial decision, and (3) the Tax Court's judicial conclusion. In summary, the Tax Court rejected the novel valuation theory applied by the Internal Revenue Service's valuation analyst in the case.*

Introduction

Valuation analysts ("analysts") are often engaged to value noncontrolling, nonmarketable interests in limited liability companies ("LLCs") for gift and estate tax compliance and/or planning purposes. The standard of value typically relied on for these gift and estate tax compliance and/or planning valuation engagements is the fair market value standard.

Internal Revenue Service Revenue Ruling 59-60 defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."[1]

In a recent U.S. Tax Court (the "Court") case—*Pierson M. Grieve v. Commissioner of Internal Revenue*[2] (the "*Grieve* case")—the Internal Revenue Service (the "Service") valuation analyst applied a theoretical methodology to value noncontrolling, nonmarketable interests in an LLC. In rendering its decision, the Court rejected this theoretical valuation methodology and deferred to the taxpayer's original valuation reports included in the gift tax return filed by Mr. Grieve.

This judicial decision was a victory for the taxpayer in the *Grieve* case and an affirmation by the Tax Court that "imaginary scenarios" which fall outside the definition of fair market value should not be relied upon in valuation analyses performed for gift and estate tax compliance and/or planning purposes. That conclusion especially holds if the facts of the case show that such scenarios are not "reasonably probable."

Background of the Case

Pierson M. Grieve was married to Florence Grieve, and they had three children. Florence died on

October 1, 2012. Their eldest child, Margaret Grieve, practiced law in the financial services industry.

From 1983 to 1996, Mr. Grieve served as chairman and chief executive officer of Ecolab, Inc. ("Ecolab"), a publicly traded corporation headquartered in St. Paul, Minnesota. During his tenure at Ecolab, Mr. Grieve acquired Ecolab stock which he and his family continue to own.

In the late 1980s or early 1990s, Mr. Grieve established the Grieve Family Limited Partnership. Pierson M. Grieve Management Corp. ("PMG") was the general partner of the Grieve Family Limited Partnership. These entities were created to preserve and manage the Grieve family wealth. Mr. Grieve consolidated management of his assets in PMG.

In the early 2000s, Margaret Grieve actively assisted Mr. Grieve with management of the family's wealth. In 2008, Margaret purchased PMG from Mr. Grieve for $6,200 and became the president of PMG. Margaret had owned all outstanding shares of PMG since 2008. Although she managed the Grieve family wealth through PMG, she never received compensation.

In 2012, Mr. and Mrs. Grieve requested assistance from a law firm to update their estate plan. Unfortunately, Florence passed away before the updated estate plan was finalized. As part of the Grieves' updated estate plan, Margaret assumed full time responsibility for managing the Grieve family wealth—as she had been responsible for investing and managing the Grieve family wealth since 2012.

Margaret worked with the law firm on the Grieves' updated estate plan which formed two pass-through entities: (1) Rabbit 1, LLC ("Rabbit"), and (2) Angus MacDonald, LLC ("Angus").

Rabbit 1, LLC, Background

On July 31, 2013, Rabbit was created as an LLC under the laws of the State of Delaware. Subsequently, on August 28, 2013, PMG contributed $2 in exchange for 20 Class A voting membership units, representing a 0.2 percent controlling membership interest in Rabbit.

On that same date, the Pierson M. Grieve Revocable Trust ("Grieve Revocable Trust") contributed $998 for 9,980 Class B nonvoting membership units, representing a 99.8 percent noncontrolling membership interest in Rabbit.

On September 3, 2013, Mr. Grieve transferred 82,984 Ecolab shares with a fair market value of $7,682,659 to Rabbit's brokerage account. Additionally, Mr. Grieve deposited cash of $1 million in Rabbit's account on September 18, 2013. As of October 9, 2013, Rabbit had no debt and a net asset value of $9,102,757.

Angus MacDonald, LLC, Background

Angus was created as an LLC under the laws of the State of Delaware on August 13, 2012, with two initial members: PMG and Florence Grieve. On September 7, 2012, PMG contributed $200 in exchange for 20 Class A voting membership units, representing a 0.2 percent controlling membership interest in Angus.

On that same date, Mrs. Grieve contributed $99,800 in exchange for 9,980 Class B nonvoting membership units, representing a 99.8 percent noncontrolling membership interest in Angus. Then on September 26, 2012, Mrs. Grieve transferred her 99.8 percent noncontrolling interest in Angus to her husband.

Exhibit 1 presents a summary of the net assets held by Angus and their respective fair market values as of November 1, 2013.

Exhibit 1
Angus MacDonald, LLC
Fair Market Value of Assets
As of November 1, 2013

Assets	Fair Market Value ($)
Cash and Short-Term Investments	$20,665,824
Limited Partnership Interests	7,316,882
Investments in Venture Capital Funds	406,406
Promissory Notes	3,581,571
Total Assets	$31,970,683

Operations of Rabbit and Angus

Rabbit and Angus were similarly managed. Margaret Grieve was the sole owner of PMG and served as the chief manager of both Rabbit and Angus.

As previously stated, PMG owned 20 Class A voting units, or a 0.2 percent controlling membership interest, in both Rabbit and Angus. The LLC agreements for Rabbit and Angus provided for reasonable compensation to Margaret for her role as chief manager, but she chose not to receive compensation.

For both Rabbit and Angus, the holder of Class A nonvoting membership units—PMG—possessed all voting powers (control) for all purposes. The holders of the Class B nonvoting membership units in Rabbit and Angus had no voting powers and could not participate in any management decisions or actions for each respective entity.

The LLC agreements for Rabbit and Angus contained provisions regarding the transfer of membership units to persons other than the initial members. Full consent of all members owning Class A voting membership units was required before a member could transfer all or part of his or her units—unless the transferee qualified as a "permitted transferee" as defined in the LLC agreements.

Permitted transferees included only lineal descendants of Mr. and Mrs. Grieve, a trust created for the exclusive benefit of any one or more of such lineal descendants and/or their spouses, and in the case of Rabbit, a charitable organization.

The Rabbit and Angus Class B nonvoting membership units have not been sold or transferred since their assignment to the Pierson M. Grieve 2013 Grantor Retained Annuity Trust (the "GRAT") and the Grieve 2012 Family Irrevocable Trust (the "Irrevocable Trust"), respectively, in 2013. Further, the Rabbit and Angus Class B nonvoting membership units have never been offered for sale.

The Gifts

Margaret Grieve, in her capacity as trustee of the Grieve Revocable Trust, assigned the 9,980 Class B nonvoting membership units of Rabbit to the GRAT on October 9, 2013. At which time, Mr. Grieve determined that the fair market value of the 9,980 Class B nonvoting units of Rabbit was $5,903,769.

South Dakota Trust Co., LLC, as trustee of the Irrevocable Trust, and Mr. Grieve executed a single-life private annuity agreement. As part of the single-life annuity agreement, Mr. Grieve assigned his 9,980 Class B nonvoting units of Angus to the Irrevocable Trust in exchange for a single-life annuity that paid an annual sum of $1,420,000.

On November 1, 2013, it was determined that the single-life private annuity had a fair market value of $8,043,675. As a result of this transaction, Mr. Grieve planned to make a net taxable gift to the Irrevocable Trust to the extent that the fair market value of his 9,980 Class B nonvoting membership units in Angus exceeded the fair market value of the single-life private annuity.

Valuation Issues and Valuation Analyst Opinions

Valuation Reports in the Gift Tax Return

In Mr. Grieve's original and timely filing of his 2013 Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, he included valuation appraisal reports prepared by Value Consulting Group ("VCG").

VCG applied an asset-based business valuation approach, specifically the adjusted net asset value method, in its analyses of the 9,980 Class B nonvoting membership units of Rabbit and the 9,980 Class B nonvoting membership units of Angus.

VCG concluded it was necessary to apply discounts for lack of control and lack of marketability to determine the fair market value of the noncontrolling, nonmarketable Class B nonvoting membership units of Rabbit and Angus.

In concluding the fair market value of the 9,980 Class B nonvoting membership units of Rabbit, VCG applied a discount for lack of control of 13.4 percent and a discount for lack of marketability of

25 percent. In concluding the fair market value of the 9,980 Class B nonvoting membership units of Angus, VCG applied a discount for lack of control of 12.7 percent and a discount for lack of marketability of 25 percent.

In selecting the discounts for lack of control applicable to the Class B nonvoting membership interests in both Rabbit and Angus, VCG relied on a study regarding control premium data and noncontrolling ownership interests held in publicly traded closed-end mutual funds.

In selecting the discounts for lack of marketability applicable to the Class B nonvoting membership interests in both Rabbit and Angus, VCG relied on restricted stock studies that addressed discounts for lack of marketability of closely held equity interests.

VCG concluded that the fair market value of the 9,980 Class B nonvoting membership units of Rabbit plus the required statutory interest was equal to the fair market value of the annuity payments received by Mr. Grieve under the GRAT agreement, as of October 9, 2013. Therefore, Mr. Grieve reported a total taxable gift of zero related to the transfer of the 9,980 Class B nonvoting membership units of Rabbit to the GRAT.

Based on the adjusted net asset value method used in its analysis, VCG concluded that the fair market value of the 9,980 Class B nonvoting membership units of Angus was $20,890,934 on a noncontrolling, nonmarketable basis as of November 1, 2013.

Mr. Grieve relied on VCG's estimate of fair market value for the 9,980 Class B nonvoting membership units of Angus and reported a net taxable gift of $9,966,659.

The Service Valuation Analyst's Opinions

Upon audit, the Service disputed the fair market values assigned to the gifts by the taxpayer. The values determined by the Service for the 9,980 Class B nonvoting membership units of Rabbit and Angus were $8,918,940 and $31,456,742, respectively. These values were estimated by an independent valuation analyst.

In his valuation analysis, the valuation analyst for the Service sought the actual price at which a 99.8 percent noncontrolling interest in both Rabbit and Angus would transact.

The Service valuation analyst concluded that any willing seller of the Class B nonvoting units in both Rabbit and Angus would first look to acquire control of the 0.2 percent interest in the entities held by the Class A voting membership unit holder in order to avoid large discounts that a willing buyer would seek.

According to his testimony, the valuation analyst for the Service opined that purchasing the Class A voting membership units would result in consolidated control and further maximize the value of the Class B nonvoting units by reducing any discount sought by a hypothetical willing buyer.

The valuation analyst for the Service began his valuation analysis for Rabbit with the net asset value stipulated by the taxpayer and the Service of $9,067,074 as of October 9, 2013. In his valuation analysis of Angus, he relied on the net asset value of Angus as determined by VCG and used in the gift tax return filed by Mr. Grieve.

To arrive at the appropriate premiums for the Class A voting units of Rabbit and Angus, the valuation analyst for the Service developed a theoretical application of the discounted net asset value method. He selected and applied a discount for lack of control and discount for lack of marketability of 10 percent and 20 percent, respectively, for both Rabbit and Angus.

This theoretical valuation approach produced a 28 percent total discount applicable to each entities' net asset value. The discounted values were then used to estimate a reasonable premium that a person would pay to acquire the Class A voting membership units.

The Service valuation analyst deducted the reasonable premium amounts from the undiscounted net asset values to determine the fair market value of the Class B nonvoting membership units of both Rabbit and Angus.

According to the valuation analyst for the Service, a hypothetical willing seller of the 9,980 Class B nonvoting membership units, or a 99.8 percent noncontrolling membership interest, would be expected to seek to limit the dollar amount of any discount sought by a hypothetical willing buyer by consolidating ownership through the acquisition of the 20 Class A voting membership units.

The valuation analyst for the Service estimated the fair market value of 9,980 Class B nonvoting membership units of Rabbit and Angus to be (1) 99.8 percent of the undiscounted net asset value of each respective entity less (2) the premium required to purchase the 0.2 percent Class A voting membership interests in each respective entity.

The valuation analyst for the Service concluded $130,000 and $450,000 to be the reasonable premiums a hypothetical seller could pay PMG for its 0.2 percent Class A voting membership interests in Rabbit and Angus, respectively.

Based on this theoretical, novel valuation methodology, the valuation analyst for the Service concluded the fair market value of the Rabbit Class B nonvoting membership units was $8,918,940, or approximately $894 per unit, and the fair market value of the Angus Class B nonvoting membership units was $31,456,742, or approximately $3,152 per unit as of the respective valuation dates.

The Taxpayer Valuation Analyst's Opinions

In response to the Service's notice of deficiency, the taxpayer relied on the valuation conclusions from another independent valuation analyst. After the taxpayer's new valuation analyst estimated the net asset value of Rabbit and Angus, he applied the market approach and the income approach to estimate the value of the 9,980 Class B nonvoting membership units of both Rabbit and Angus.

The market approach and income approach are generally accepted business valuation approaches often considered and applied in valuation analyses prepared for gift and estate tax compliance and planning purposes.

In his market approach analysis, the valuation analyst for the taxpayer analyzed and relied upon publicly traded closed-end mutual funds to estimate the discount for lack of control and relied upon restricted stock studies to estimate the discount for lack of marketability.

Based on the market approach analysis, the taxpayer's valuation analyst selected a discount for lack of control and a discount for lack of marketability of 15.1 percent and 25.0 percent, respectively, and applied these selected discounts to the net asset value of Rabbit. He also selected discounts for lack of control and lack of marketability of 12.6 percent and 25.0 percent, respectively, and applied these selected discounts to the net asset value of Angus.

Although the selected discounts were different, the market approach he applied was like the approach applied in the VCG analysis.

The taxpayer's valuation analyst also used the income approach in his analysis of the Class B nonvoting membership units of Rabbit and Angus. In his income approach analysis, he estimated the price a hypothetical investor would pay for the 9,980 Class B nonvoting membership units by considering investment risks and expected rates of return based on empirical studies regarding required rates of return for investments that lack control and marketability.

The taxpayer's valuation analyst assigned equal weight to the value indications derived from the market and income approaches to reach his conclusion of $5,884,000 (or $590 per unit) for the 9,980 Class B nonvoting membership units in Rabbit and $19,854,000 (or $1,989 per unit) for the Class B nonvoting membership units in Angus.

The Court's Opinion on the Valuation Issues

In its opinion, the Court rejected the novel valuation theory relied upon by the valuation analyst for the Service. In doing so, the Court noted that the focus should be on the value of the Class B nonvoting membership units on the date of the gifts and hypothetical willing investors, not the value of the

> "[T]he Court did not consider the hypothetical willing investor argument consistent with the definition of fair market value in Revenue Ruling 59-60. . . ."

Class B nonvoting membership units on the basis of imaginary subsequent events.

The Court emphasized the reliance on the definition of fair market value from Revenue Ruling 59-60 when it stated the following:

> To determine the fair market values of the Class B (nonvoting) units we look at the willing buyer and willing seller of the Class B (nonvoting) units, and not the willing buyer and willing seller of the Class A units.

Further, the Court noted the holder of the Class A voting membership units in both Rabbit and Angus, Margaret Grieve, as sole owner of PMG, had testified that she had no intention of selling the controlling membership interests, and certainly not at the premium that was estimated by the valuation expert for the Service.

The Court highlighted that reports prepared by the valuation expert for the Service did not include or rely on empirical data which supported his estimated 5 percent premium that a hypothetical willing seller of the Class B nonvoting membership units would expect for the Class A voting membership units.

The Court emphasized that the Service valuation analyst (1) provided no evidence indicating that his theoretical valuation methodology had ever been subjected to peer review and (2) cited no case law to support this valuation methodology.

In the Court's conclusion, it found no reason to object to the discounts for lack of control and lack of marketability applied in the VCG valuation reports originally filed with the taxpayer's gift tax return. Further, the Court found the fair market value estimates presented in the VCG valuation reports to be the most reliable.

Summary and Conclusion

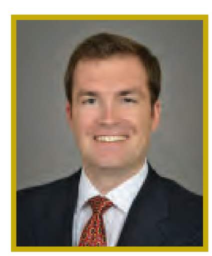
The takeaways to be considered from the *Grieve* decision are listed below.

- While the argument presented by the valuation analyst for the Service had intuitive economic appeal, the Court did not consider the hypothetical willing investor argument consistent with the definition of fair market value in Revenue Ruling 59-60 and consistent with valuation analyses prepared for gift and estate tax compliance and planning purposes.
- Valuations prepared for gift and estate tax compliance should provide an estimate of fair market value for the property as of the date of the gift without consideration of "imaginary subsequent" scenarios that are not "reasonably probable" based on the explicit facts of the case.
- The fact that the controlling member of Rabbit and Angus—Margaret Grieve as sole owner of PMG—testified she had no intention of selling the controlling membership interests in the entities—and that she would have required much higher premiums than those estimated by the valuation analyst for the Service, is reasonably expected to have influenced the Court in its decision to reject the Service valuation analyst's theoretical valuation methodology.
- For cases involving discounts used to estimate the fair market value of property for gift and estate tax compliance purposes, it seems likely more of these types of challenges will be brought by the Service at the agent level, but the facts from the Grieve case seem to be on the side of the taxpayer.
- The Internal Revenue Service will not necessarily ignore GRAT transaction values which may work in favor of the taxpayer depending upon the facts and circumstances surrounding the case.
- Valuation analysts, in certain instances, may have to testify jointly or concurrently at the request of the Court.

Notes:

1. Rev. Rul. 59-60 (159-1 C.B. 237).
2. Pierson M. Grieve v. Commissioner, T.C. Memo 2020-28 (March 2, 2020).

Chad Kirkland is a manager in our Chicago practice office. Chad can be reached at (773) 399-4303 or at cmkirkland@willamete.com.



On Our Website

Recent Articles and Presentations

Connor Thurman, a senior associate in our Portland office, and Robert Reilly, a managing director of our firm, authored an article that appeared in the November 2000 issue of the *Practical Tax Lawyer*. The title of Connor and Robert's article is "Measurement of Functional and Economic Obsolescence in the Industrial or Commercial Property Valuation, Part 1."

Considerations of functional obsolescence and external obsolescence are important procedures in the application of the cost approach to value industrial or commercial property. Connor and Robert's article summarizes best practices for both the identification and the measurement of obsolescence. First, the article summarizes what tax counsel needs to know about the various forms of obsolescence. Second, this article summarizes what tax counsel needs to know about the practical procedures that may be applied to recognize the existence of any property obsolescence and measure the amount of any property obsolescence. Third, their article considers various issues related to documenting the existence of any property obsolescence. Fourth, this article suggests potential tax counsel responses to assessment authority objections regarding the recognition of obsolescence in the application of the cost approach in the industrial or commercial property assessment.

Fady Bebawy, a vice president in our Chicago office, authored an article that appeared in the Fall 2020 issue of *Deal Points.* The title of Fady's article is "Are Fairness Opinions Enough—M&A Transaction Valuation Considerations Vis-à-Vis Post-Transaction Shareholder Litigation."

Fady's article examples certain factors that call into question the reliability of a fairness opinion. These factors may lead to more post-transaction shareholder litigation. Fady concludes with considerations for providing a shareholder valuation opinion and eliminating the conflict of interest optics that can occur when investment bankers provide both investment banking services and fairness opinion services.

Kyle Wishing, a vice president in our Atlanta office, authored an article that appeared in the Summer 2020 issue of *Journal of Employee Ownership*. The title of Kyle's article is "Valuation Treatment of the Repurchase Obligation Liability."

Kyle's article begins by discussing the concept of the repurchase obligation for ESOP companies in general. He goes on to examine the underlying valuation theory and the various regulations that affect this obligation. Kyle explores the various interpretations of fair market value that can affect the repurchase obligation issue. For example, there is the transfer tax interpretation, the ESOP-hybrid interpretation, and the within-ESOP interpretation. Kyle presents an illustrative example of the valuation treatment of the repurchase obligation using the ESOP-hybrid interpretation and the within-ESOP interpretation. He presents both an implicit repurchase obligation application and an explicit repurchase obligation application.

Robert Reilly delivered a presentation to the ASA Philadelphia Chapter Business Valuation Conference, which was held September 10, 2020. The conference was sponsored by the Philadelphia Chapter of the American Society of Appraisers.

Robert begins his presentation with an introduction to pass-through entities. He goes on to discuss the fundamentals and mathematics of tax-affecting. Robert then reviews the position of the IRS on tax-affecting. He summarizes recent judicial precedent on this topic. Robert wraps up his presentation with a detailed presentation on the Estate of Aaron U. Jones v. Commissioner case (in which Robert testified).

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the August 2020 issue of the *Journal of Multistate Taxation and Incentives*. The title of Robert's article was "Working with a Valuation Specialist in the Appeal of a Unit Principle Valuation."

Robert Reilly also authored an article in the September 2020 issue of the *Journal of Multistate Taxation and Incentives*. The title of that article was "Due Diligence Interviews in Unit Principle Valuations."

Robert Reilly was the co-editor of the American Bankruptcy Institute book published in 2020 and titled *Developing the Evidence Using Prospective Financial Information in Bankruptcy and Other Litigation for Business Valuation, Damages, and Other Applications*.

Robert Reilly had an article reprinted on the National Association of Certified Valuators and Analysts ("NACVA") online publication at www.quickreadbuzz.com. The article appeared in the March 21, 2018, issue. The title of that article was "Transferring Closely Held Company Equity To a Key Employee."

Fady Bebawy, Chicago office vice president, had an article published in the Fall 20202 issue of *Deal Points: The Newsletter of the Mergers and Acquisition Committee* published by the American Bar Association. The title of Fady's article was "Are Fairness Opinions Enough—M&A Transaction Valuation Considerations vis-à-vis Post-Transaction Shareholder Litigation."

Kyle Wishing, Atlanta office vice president, had an article published in the National Association of Certified Valuators and Analysts online publication at quickreadbuzz.com on June 10, 2020. The title of Kyle's article was "Valuation Treatment of the ESOP: Repurchase Obligation Liability."

In Person

Kevin Zanni, Chicago office managing director, co-presented a webinar to the California Water Association and the California Water Boards on August 19, 2020. The title of that presentation was "Water System Valuation—RCNLD Analysis."

Curtis Kimball, Atlanta office managing director, co-presented two different sessions at the ALI/CLE Estate Planning for the Family Business Owner 2020, Part 1, webinar on October 8, 2020. The first presentation was titled "Leveraged Estate Planning in Light of the 2020 Economy," and the second presentation was titled "Cases Involving Valuation, including Formula Clauses."

Curtis Kimball and Weston Kirk, Atlanta office vice president, delivered a presentation on June 17, 2020, to the American College of Trust and Estate Counsel Business Planning Meeting during their Summer 2020 virtual meeting. The title of their presentation was "Current Topics in Valuation."

Weston Kirk delivered a presentation on September 9, 2020, to the finance 4000 course students of Georgia State University J. Mack Robinson College of Business. The title of his presentation was "Introduction to Business Valuation."

Weston Kirk also delivered a similar presentation on June 10, 2020, to the Graduate Business Association members of the Georgia State University J. Mack Robinson College of Business.

Encomium

Dean Driskell, Atlanta managing director, is a member of an American Institute of Certified Public Accountants ("AICPA") Task Force focusing on bankruptcy issues. The AICPA Task Force findings were presented to the American Bankruptcy Institute in October 2020.

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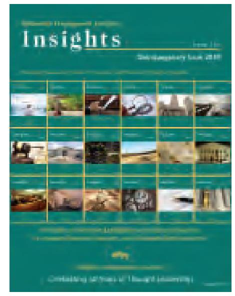

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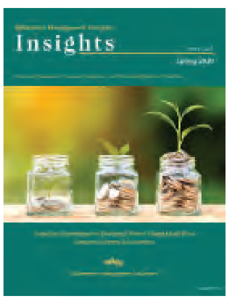

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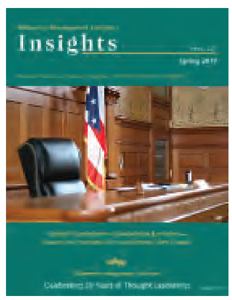

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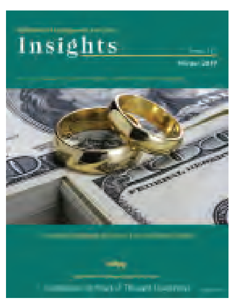

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Willamette Management Associates provides thought leadership in business valuation, forensic analysis, and financial opinion services. Our professional services include: business and intangible asset valuation, intellectual property valuation and royalty rate analysis, intercompany transfer price analysis, forensic analysis and expert testimony, transaction fairness opinions and solvency opinions, reasonableness of compensation analysis, lost profits and economic damages analysis, economic event analysis, M&A financial adviser and due diligence services, and ESOP financial adviser and adequate consideration opinions.

We provide thought leadership in valuation, forensic analysis, and financial opinion services for purposes of merger/acquisition transaction pricing and structuring, taxation planning and compliance, transaction financing, forensic analysis and expert testimony, bankruptcy and reorganization, management information and strategic planning, corporate governance and regulatory compliance, and ESOP transactions and ERISA compliance.

Our industrial and commercial clients range from substantial family-owned companies to Fortune 500 multinational corporations. We also serve financial institutions and financial intermediaries, governmental and regulatory agencies, fiduciaries and financial advisers, accountants and auditors, and the legal profession.

For 50 years, Willamette Management Associates analysts have applied their experience, creativity, and responsiveness to each client engagement. And, our analysts are continue to provide thought leadership—by delivering the highest level of professional service in every client engagement.

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