CHAPTER 1

Introduction

COPYRIGHTED MATERIAL
http://www.pbookshop.com

In our daily lives we have come to expect—even demand—comfort, convenience, and choice. When we desire entertainment, we click on the remote and at our fingertips are hours of television viewing. When we want to speak with someone, we take out our portable telephone and dial the number, and we are instantly in conversation with someone who may be far away. We can change the climate in our home from hot to cold and back to hot simply by moving a dial. We can access encyclopedias with a few computer keystrokes. There is fast food, ethnic food, gluten-free food, carbohydrate-free food, fat-free food, and so on. Never before has so much been available so quickly to so many people.

Curiously, it seems like very few people—myself included—care how all of these things happen. I don't know what enables my car to do what it does. I don't know why my television, telephone, refrigerator, or any other household appliance works. Ask me why certain diets are better for me—I don't know and I don't care. It only matters to me that these things work when I want them to.

You may ask why any of this matters in a book about valuing pass-through entities. The reason is that if you are like the consumer who is described in the previous two paragraphs, looking for a quick and simple method to everything, including valuing any pass-through entity under any circumstance, then this book is not for you. This book does not offer a simple how-to valuation manual because there are no simple answers to complex valuation questions. This book is for business appraisers and users of business appraisals who need to look behind the curtain and understand the choices and issues associated with valuing a pass-through entity. It describes the process of developing a supportable, proper pass-through entity valuation conclusion.

DEFINITION OF VALUE

Value has been described by many people in many ways. Karl Marx said that "[n]othing can have value without being an object of utility."[1] Publius Syrus said that "[e]verything is worth what its purchaser will pay for it."[2] Contradicting Publius Syrus was John Ruskin, who said, "A thing is worth precisely what it can do for you; not what you choose to pay for it."[3] And leave it to Mark Twain to cleverly illustrate value: "Each person is born to one possession which outvalues all his others—his last breath."[4] For purposes of this book in connection with business appraisals, *value* is defined as the risk-adjusted present value of the future economic returns associated with the ownership of a business interest.

BEAUTY AND VALUE

Value, like beauty, is in the eye of the beholder. What may have extraordinary beauty to someone may not be beautiful to another. The same holds true regarding the value of a business ownership interest. A business ownership interest may have great value to one person but not another. Therefore, one's perspective greatly impacts value.

When valuing a business interest, the appraiser must gain an understanding of the control attributes of the business ownership interest being appraised and the purpose of the appraisal. Let's discuss both of these factors.

http://www.pbookshop.com

Control versus Noncontrolling Interests

The business interest being appraised may permit the holder to exercise the prerogatives of control. When valuing a controlling interest in an entity, the controlling interest generally has greater value than the minority interest, all other things being equal. The issue of control relates to various factors, the most important of which is the ability of the controlling owner to make decisions and select strategies without regard to minority owners. Due to the absence of control in a minority interest, the appraiser of a minority equity interest may need to consider a reduction beyond the mere pro rata value of the minority owner's interest in the entity. Thus, when valuing a business

[1] BrainyQuote, http://www.brainyquote.com/quotes/quotes/k/karlmarx157970.html.
[2] The Quotations Page, http://www.quotationspage.com/quote/34596.html.
[3] John Ruskin, "Athena in the Heart," in *The Works of John Ruskin: The Queen of the Air*, 123, 147 (1874).
[4] TwainQuotes, http://www.twainquotes.com/Life.html.

3GC01 09/18/2014 7:46:43 Page 3

ownership interest, it is important to be mindful of the degree of control associated with the subject interest.

Standards of Value

The next consideration is the purpose of the business appraisal. There are many different reasons that a business appraisal is required:

1. Transactions (including, but not limited to, leveraged buyouts, employee stock ownership plans, employee compensation plans, and initial public offerings)
2. Litigation (matrimonial dissolution, bankruptcy, contractual disputes, owner disputes, and employment and intellectual property disputes)
3. Compliance-oriented engagements (financial reporting and tax matters (i.e., corporate reorganizations, S corporation conversions, estate and gift tax compliance, purchase price allocations, and charitable contributions))
4. Planning-oriented engagements (estate and gift tax planning, mergers and acquisitions, and personal financial planning)[5]

The purpose of the valuation will determine the perspective from which the valuation is being performed:

1. A known holder or seller (often referred to as the fair value standard of value in a dissenting shareholder rights or matrimonial dissolution context)[6]
2. A known or hypothetical buyer (also known as the investment value standard of value)
3. Fair market value, which has been defined as

> [t]he 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

http://www.pbookshop.com

[5]Consulting Services Executive Committee, American Institute of Certified Public Accountants, "Valuation of a Business Ownership Interest, Security, or Intangible Asset," 5 (June 2007).
[6]Under U.S. generally accepted accounting principles, *fair value* has a different meaning not utilized in this text.

3GC01 09/18/2014 7:46:43 Page 4

> well informed about the property and concerning the market for such property.[7]

It is critical to understand the standard of value because a different perspective may yield a different investment return. For example, the holder of a controlling equity ownership interest may enjoy certain synergistic benefits with other businesses that an unaffiliated investor may not have. Conversely, the investor may be able to access sources of financing, provide depth of management, have a lower cost of capital, implement efficiencies, and so forth, that provide an investor a greater return than the present owner can achieve. In addition, one standard of value may be impacted by federal and state laws (i.e., fair market value), whereas a different standard of value may not. Accordingly, different perspectives and standards of value yield different risk-adjusted returns—and ultimately different values. There is no single approach that is applicable to all appraisals.

http://www.pbookshop.com

PREMISE OF VALUE

There are two fundamental premises upon which a company may be valued: as a going concern or as if in liquidation.[8] The value of a company is most often determined to be the higher of these two values. This concept is consistent with the real estate appraisal concept of "highest and best use," which requires an appraiser

> to consider the . . . optimal use of the assets being appraised under current market conditions. If a business [is expected to] command a higher price as a going concern[,] then it should be valued as such. Conversely, if a business [is expected to] command a higher price if it is liquidated, then it should be valued as if in liquidation.[9]

[7]Rev. Rul. 59–60, 1959-1 C.B. 237, § 2.01(as defined in § 20.2031-1(b) of the Estate Tax Regulations (§ 81.10 of the Estate Tax Regulations 105) and § 25.2512-1 of the Gift Tax Regulations (§ 86.19 of Gift Tax Regulations 108).

[8]In liquidation, a company can be valued (1) as an "assemblage of assets but not in current use in the production of income"; (2) "on a piecemeal basis . . . as part of an orderly disposition"; and (3) "on a piecemeal basis . . . as part of a forced liquidation." Charles A. Wilhoite, *Defining and Estimating "Value" in the LLC Setting*, 10–12 (July 20, 2013), available at http://www.willamette.com/pubs/presentations2/wilhoite_aba_conf_2013.pdf (quoting *Valuing a Business*, 33 [4th ed., 2000]).

[9]William P. Dukes, "Business Valuation Basics for Attorneys," *Journal of Business Valuation and Economic Loss Analysis* 1(1) (2006).

For purposes of this text, we have assumed a going-concern premise of value for the concepts and examples provided herein.

APPROACHES TO VALUE

Our next step is to consider the different approaches to valuation. There are three generally accepted approaches to value:

- The *income approach* determines the value of

  "a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated benefits into a present value single amount." The application of the income approach establishes value by methods that discount or capitalize earnings and/or cash flow, by a discount or capitalization rate that reflects market rate of return expectations, market conditions, and the relative risk of the investment.[10]

- The *market approach* calculates the value of

  "a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar business, business ownership interests, securities, or intangible assets that have been sold." Generally, this can be accomplished by a comparison to publicly traded guideline companies or by an analysis of actual transactions of similar businesses sold. It may also include an analysis of prior transactions in the company's stock, if any.[11]

- The *asset (cost) approach* requires estimates of the individual market values of the subject company's assets and liabilities, if applicable, to

http://www.pbookshop.com

[10] James R. Hitchner and Michael J. Mard, *Financial Valuation Workbook*, 27 (3rd ed., 2011) (quoting "International Glossary of Business Valuation Terms," in *American Institute of Certified Public Accountants, Statement on Standards for Valuation Services*, no. 1, at 45, app. B, http://www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/DownloadableDocuments/Intl%20Glossary%20of%20BV%20Terms.pdf).

[11] *Id.* (quoting "International Glossary of Business Valuation Terms," in *American Institute of Certified Public Accountants, Statement on Standards for Valuation Services*, no. 1, at 46, app. B, http://www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/DownloadableDocuments/Intl%20Glossary%20of%20BV%20Terms.pdf).

3GC01 09/18/2014 7:46:43 Page 6

derive an adjusted net asset value (i.e., equity value). The asset approach is often referred to as a *balance sheet approach*.

There are two methods that are often considered when employing the income approach: the capitalization of earnings method and the discounted future returns method (or permutations of these methods). There are also two methods that are often considered when employing the market approach: the guideline transaction method and the guideline public company method.

When considering the potential for different permutations of control, standards of value, valuation approaches, and valuation methods, there are 30 different potentially viable valuation calculations that must be considered, as shown in Table 1.1.

TABLE 1.1 Potential Valuation Calculations

http://www.pbookshop.com

	Controlling Interest	Noncontrolling Interest
Income Approach		
Value to Seller		
Capitalization of Earnings Method	1	2
Discounted Future Returns Method	3	4
Value to Buyer		
Capitalization of Earnings Method	5	6
Discounted Future Returns Method	7	8
Fair Market Value		
Capitalization of Earnings Method	9	10
Discounted Future Returns Method	11	12
Market Approach		
Value to Seller		
Guideline Transaction Method	13	14
Guideline Public Company Method	15	16
Value to Buyer		
Guideline Transaction Method	17	18
Guideline Public Company Method	19	20
Fair Market Value		
Guideline Transaction Method	21	22
Guideline Public Company Method	23	24
Asset (Cost) Approach		
Value to Seller	25	26
Value to Buyer	27	28
Fair Market Value	29	30

3GC01 09/18/2014 7:46:43 Page 7

Internal Revenue Code (IRC) Revenue Ruling 59–60 recognizes that there is not one and only one way to value a business ownership interest, stating thus:

> A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.[12] Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation 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.[13]

Just as we want instant gratification when we turn on the television, clients and users of business appraisals want instant gratification when they ask their valuation questions. However, as evidenced by all of the valuation calculation possibilities noted earlier, the work needed to complete each analysis, and the guidance set forth in Revenue Ruling 59–60, there is no quick, reliable way to shortcut the process; in other words, there is no one-size-fits-all solution.

http://www.pbookshop.com

THE PTE CONUNDRUM

Even when two valuation consultants agree as to the degree of control, the standard of value, the approach, and the method to apply, they may still conclude that the subject ownership interest has a significantly different value. Valuation conclusions often differ because the inputs used to apply a particular methodology may be very different. Valuation analysts may have different expectations as to the future earnings potential, costs, or riskiness of a business. There are many other issues that complicate the valuation analysis. One issue is that there are different types of business entities, that is, C corporations, S corporations, partnerships, limited liability

[12]Although Revenue Ruling 59–60, § 3.01, specifically addresses the use of the fair market standard of value in connection with estate and gift tax valuations, the guidance set forth therein with respect to the approach to valuation also applies to other standards of value in situations other than estate and gift tax valuation.
[13]Rev. Rul. 59–60, 1959-1 C.B. 237, § 3.01.

companies (LLCs), and sole proprietorships. Depending on the form of the entity, different tax laws govern the recognition of income and losses at the entity and owners' level.[14] The after-tax cash flows to an owner can be materially different depending on the entity form. Accordingly, entity form may impact value.

When the after-tax net income of a C corporation is distributed to its owners, there is a second level of income taxes (a tax on dividend income) paid at the owner level. On the other hand, with rare exceptions, S corporations, partnerships, LLCs, and sole proprietorships do not pay income taxes at the entity level; such entities "pass through" their earnings and losses to their owners. Accordingly, S corporations, partnerships, LLCs, and sole proprietorships are collectively referred to herein as *pass-through entities (PTEs)*. The earnings of PTEs are therefore subjected to income tax only one time, at the owner level. Owners of interests in S corporations, partnerships, and LLCs are known as *shareholders* (or *stockholders*), *partners*, and *members*, respectively. The entity status as either a C corporation or a PTE can fundamentally impact after-tax future cash flows of a business ownership interest, and hence the value of that ownership interest. Table 1.2 illustrates this concept.

Applying the simplified assumptions contained in this example, the after-tax income for an owner of a PTE (60%) is 25 percent greater than the after-tax income for an owner of a C corporation (48%).

PTEs are often valued under the income approach and the market approach, utilizing data derived from public company transactions. Such

http://www.pbookshop.com

TABLE 1.2 Example of C Corp vs. PTE Income Available After All Income Taxes

	C Corp	PTE
Pretax income	100.0%	100.0%
Corporate tax income	40.0%	0.0%
Available earnings	60.0%	100.0%
Dividend tax rate [1]	12.0%	0.0%
Individual income tax rate	0.0%	40.0%
	12.0%	40.0%
Available after all income taxes	48.0%	60.0%

[1] The dividend tax is calculated in this example as follows:
Dividend tax rate (20%) multiplied by available earnings (60%) equals 12%.

[14] C corporations are subject to the Internal Revenue Code of 1986, as amended (IRC), subchapter C; partnerships are subject to IRC subchapter K; and S corporations are subject to subchapter S of chapter 1 of the IRC.

3GC01 09/18/2014 7:46:43 Page 9

data would be presumed to be relevant as it reflects many thousands, even millions, of potentially relevant transactions between buyers and sellers. However, if a C corporation yields different after-tax investor returns than PTEs, how can a valuation analyst justify applying valuation multiples developed from tax-paying entities in connection with the valuation of a PTE? The answer is to somehow quantify the tax benefit, if any, associated with an entity's status as a PTE. The issue of how to quantify that tax benefit has vexed valuation analysts for years. I call this issue the *PTE conundrum*.

The PTE conundrum is a hotly debated topic among valuation analysts, with points of view evolving and changing over time. Certain valuation analysts ignore all entity-level income taxes, deeming such income taxes hypothetical, improper, and inappropriate. Some valuation analysts impose C corporation income taxes at maximum marginal rates on the earnings of a business for valuation purposes. Alternatively, an effective combined corporation federal and state tax rate of 40 percent is utilized by many valuation analysts. U.S. courts have issued varying and seemingly conflicting decisions on this issue, based on different facts and circumstances.

How to quantify the tax benefit of PTE status is a challenge when valuing companies for mergers and acquisitions, estate and gift tax purposes, marital dissolution, shareholder disputes, and other purposes. It is an issue when applying different standards of value, such as fair market value, fair value, and investment value.

The following chapters provide a potential solution to the PTE conundrum. The text includes a discussion of (1) applicable tax law, (2) different valuation approaches (the income, market, and cost approaches), and (3) standards of value (value to the holder/seller, value to the buyer, and fair market value). Significant cases and the manner in which different business appraisers have attempted to value the PTE tax benefit are presented and critiqued. Solutions, examples, and a sample case that illustrates the thought process and logic of parties to a hypothetical transaction are also contained in the following text.

http://www.pbookshop.com

http://www.pbookshop.com