

CORPORATE  
VALUATION  
SERVICES, INC.

**Client Focus:  
Current Business Valuation Issues –  
W / Tax & Discounts Focus**

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Mr Garvy is currently President of Corporate Valuation Services, Inc (CVS) Prior to forming CVS, he was Managing Partner for valuation and litigation support services at the firm Chadwick & Garvy LLC. He has appraised billions of dollars of equity interests throughout the country and given court testimony in taxation, partnership disputes, divorce matters, intellectual property litigation and rendered fairness opinions.

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“The Evolving Role and Impact of the CPA Appraiser / Expert Witness” - *DuPage County (IL) Bar Association’s Brief Magazine*, January 2009.

“Appraisal Opportunities and Challenges in a Down Market” - *Illinois State Bar Association’s Trusts & Estates Quarterly Newsletter*, April 2009.

“Discounts: Where are We Now” – *Trusts & Estates Magazine*, (yet to be published).

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Accredited Senior Appraiser (ASA) – American Society of Appraisers

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Master of Business Administration, Kellogg School of Management (Northwestern University)

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# Topics to Cover

- Basic appraisal issues to keep in mind w/ clients
- Ongoing issues with Discount for Lack of Marketability
- Built-in Gains Taxes & Valuation: Jelke & Litchfield
- Tax-Affecting S Corps (or lack thereof): Gross Case
- Professional (Personal) Goodwill v. Enterprise Goodwill

# Basics....

- Three main approaches to appraise a business: Cost, Market & Income.
- The Cost approach is balance sheet driven and usually only employed for holding companies and non-profitable businesses.
- The market approach has two main methods the Transactional Market Method and the Publicly-traded Guideline Company Market Method (PGCM).
- Companies with revenues above \$20MM should have a serious effort at applying a Publicly traded guideline market method. Rev. Ruling 59-60 favors this approach.



## Basics...that appraisers make mistakes on!

- The Gordon Growth model is a way of simply capturing the income approach:

$$V_e = \frac{C_f}{(k-g)}$$

- Where:

$V_e$  = Value of Equity

$C_f$  = Cash Flow (or other benefit stream)

$K$  = Discount Rate (Risk Rate)

$G$  = Long-term Growth Rate



## Basics...that appraisers make mistakes on!

- The Market Approach and the Income Approach are related!
  - A market multiple (i.e. P/E) is inverted it gives a Capitalization Rate.
- Take-Aways:
  - For larger companies your appraiser should perform a PGCM – the IRS will look for it.
  - The value indication between the Income and Market approaches should be very close otherwise there is probably some problems in the analysis (See Heck Case)!



## Heck Case = Valuation Blunder

- Estate of Heck v. Commissioner T.C. Memo 2002-34
  - IRS's expert witness – Dr. Spiro arrived at Korbel's equity value in estate at \$30,177,000 or \$47,900 per share.
  - Spiro used an Income and a Market Approach. Market approach used only one Guideline Company: Mondavi.
  - The indicated value from Income approach: \$36,150 per share which he gave 70% weighting and for the Public Guideline Method: \$65,209 per share which he gave 30% weighting.
  - While Tax Court opined: "When appropriate, its [PGCM] usage is mandated by Sec 2031 (b) [Gross estate includes FMV of unlisted stock], which provides that the value of unlisted shares of stock or securities "shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or similar lines of business which are listed on an exchange."
  - The biggest issue, in our view is that the PGCM value is 80% greater than the income approach!



## The Ongoing Issues with Marketability Discounts

### Cases to Review:

- McCord (2003 TC and 2006 Appeals Reversal)
- Clarissa W. Lappio v. Commissioner (2003)
- Estate of Kelley v. Commissioner (2005)
- Litchfield v. Commissioner (2009)



## The Ongoing Issues with Marketability Discounts

### McCord Case:

- First major case with IRS relying on Dr. Bajaj's study "Firm Value and Marketability Discounts" in the Journal of Corporation Law, 2001
- Taxpayer: DLOC of 22% and DLOM of 35%
- IRS / Bajaj: DLOC of 8.34% and DLOM of 7%
- Tax Court: DLOC of 15% and DLOM of 20%
  
- Years later, in 2006, Court of Appeals reversed and remanded back for consideration along tax payers lines...since burden of proof was agreed to be the Commissioners. CoA noted that T.C. "may have simply just split the baby with a calculator."



## The Ongoing Issues with Marketability Discounts

### Clarissa W. Lappio v. Commissioner:

- Gift tax case with FLP with Real Estate and Muni Bonds
- Taxpayer: DLOC of 7.5% and DLOM of 35%
- IRS / Bajaj: DLOC of 8.5% and DLOM of 8.3%
- Tax Court: DLOC of 15% and DLOM of 24%
- Court noted that the Bajaj study had some credibility but IRS expert was not prepared to present the findings and didn't just want to rely on one academic article

## The Ongoing Issues with Marketability Discounts

Estate of Kelley v. Commissioner (October 2005):

- The Tax Court allowed a combined 32% combined discount for lack of control and marketability for a decedent's 94.83% FLP owning only cash and CDs!
- Taxpayer: DLOC of 25% and DLOM of 38%
- IRS / Bajaj: DLOC of 12% and DLOM of 15%
- Tax Court: DLOC of 12% and DLOM of 23% (32% combined discount for basically cash!)
- Court cited McCord case and Lappio case to adjust upwards from Bajaj Study – Further Loss of IRS
- IRS now losing progressively on FLP cases.

## The Ongoing Issues with Marketability Discounts

Changes in Rule 144 & lower DLOM in recent stock studies

- Rule 144 was adopted by SEC in 1972
- Adjusted in 1983, 1990 and 1997
- Adjustments in 1990 and 1997 brought holding period from 3 years down to 1 years for non-affiliated owners of these restricted stock
- Result is recent stock studies have yielded lower DLOMs -> this makes sense and validates prior studies.
- However, Courts gravitate towards recent data (See Litchfield Case Opinion). Business Valuation community must generate new ways to quantify the DLOM.



## What Have We Been Seeing?

- FLPs are still very strong discounting vehicle
- DLOCs as high as just below 20% for early 2009 discount studies -> market spread increased from NAV on closed-end funds due to sell-off...now tightening again.
- Discount for Lack of Marketability less than 30% for liquid FLPs (20 – 25%)
- We encourage: Waiver of partition, assignees rights to be less than full limited partners, tougher right of first refusal language, etc. with our estate planners to increase discounts.

## DLOM: Applied

Source / Study	Average	Comparability to Subject Interest			Comments
		Little	Somewhat	Highly	
SEC Institutional	25.8%			Yes	Includes OTC non-reporting companies
Gelman	33.0%	Yes			Investment companies; detail unavailable
Mooroney	35.8%		Yes		Investment companies: statistical application
Maher	35.4%			Yes	Investment companies: relatively small companies
Trout	43.5%		Yes		Investment companies: statistical application
Standard Research Consulting	45.0%			Yes	Private Placement: very small companies
Willamette	31.2%		Yes		Private Placement: data unavailable
Silber	33.8%			Yes	Private Placement: very small companies
FMV	23.0%			Yes	SIC, private placement, small companies
Johnson	20.0%	Yes			Detail unavailable
MPI	29.0%			Yes	Private placements, data unavailable
Columbia	21.0%	Yes			Detail unavailable
Average of Sources	31.4%			32%	



## DLOM: TAKE-AWAYS

- Historically, the most scrutinized areas of any appraisals are always the discounts & premiums
- Nothing is more contested than the DLOM
- Its incumbent upon the appraiser to compare the Subject Interest with the various studies and explain the reasoning of their discount selected. See Example in hand-out materials.

## Built-In Gains Taxes & Valuations

- Estate of Davis v. Commissioner 110 T.C. 530 (1998) both sides agreed a willing buyer would have taken built-in tax liability into account in purchase price.
- Eisenberg v. Commissioner 155 F.3d 50 (2d Cir. 1998) Second Circuit found that the T.C. had erred by not considering built-in Capital Gains Tax Liability. The IRS recognized “to the extent that there is no legal prohibition against such discount.”
- Estate of Dunn v. Commissioner 301 F.3d 339 (5<sup>th</sup> Cir. 2002) the Fifth Circuit applied a dollar for dollar discount for unrealized capital gains.... The court opined: “...the very definition of the asset-based approach contemplates the consummation of the sale of the asset being valued, triggering the built-in gains tax.”

## Litchfield Case: DLOC, DLOM and Built-in Gains

- Litchfield v. Commissioner T.C. 2009-21 (January 29, 2009) was a decision regarding two S-Corp holding companies. Decision concerned DLOC, DLOM and Built-in Gains
- Litchfield was litigated before Jelke 11<sup>th</sup> Circuit Decision so Built-in Gains was argued on an incremental basis.
  - Estate's expert looked at historical asset turnover AND Board minutes = 5 years for LRC and 8 years for LSC.
  - IRS Expert looked at only historical information = 54 years for LRC and 29 Years for LSC.
- Court criticized IRS for not meeting with management (fundamental mistake!)
- Court was frustrated that Estate didn't present more recent data concerning restricted stock studies.
- Summary Analysis in your handouts – We have article we wrote concerning this case – we can email you – just ask.

## Litchfield Case: DLOC, DLOM and Built-in Gains

	Estate Expert	IRS Expert	Court's Decision
<b>LRC</b>			
NAV	\$33,174,196	\$33,174,196	\$33,174,196
Estate's 43.1%	9,751,757	9,751,757	9,751,757
Discounts			
Built-in Gains Taxes	17.4%	2.0%	17.4%
Lack of Control	14.8%	10.0%	14.8%
Lack of Marketability	36.0%	18.0%	25.0%
Computed FMV	\$6,475,000	\$10,069,886	\$7,546,725
Imputed total discount	54.7%	29.6%	47.2%
<b>LSC</b>			
NAV	\$52,845,562	\$52,845,562	\$52,845,562
Estate's 43.1%	12,133,341	12,133,341	12,133,341
Discounts			
Built-in Gains Taxes	23.6%	8.0%	23.6%
Lack of Control	11.9%	5.0%	11.9%
Lack of Marketability	29.7%	10.0%	20.0%
Computed FMV	\$5,748,000	\$9,565,535	\$6,530,790
Imputed total discount	52.6%	21.2%	46.2%



## Jelke Reversal

- Estate of Jelke III v. Commissioner 507 F.3d 1317 (11<sup>th</sup> Cir Court 2007) the 11<sup>th</sup> Circuit Court of Appeals reversed the Tax Court and adopted the rationale in the Estate of Dunn case by giving a dollar for dollar unrealized capital gains liability discount as of the date of valuation.
- The Court noted: “this 100% approach settles this issue as a matter of law, and provides certainty that is typically missing in the valuation area.” Dissenting judge dismissed ruling as majority adopting the “doctrine of ignorable ease and seductive simplicity.”



## Appraisals of S-Corps & Pass Thru Entities

- Review of Gross Case (2001 FMV tax case) and Open MRI v. Kessler (2006 Del. Chancery Case)
- Gross v. Commissioner T.C. Memo 1999-254 and Affirmed in the 6<sup>th</sup> Circuit of Appeals, 2001, (However Writ was denied to the U.S. Supreme Court). Gift Tax Case involving stock of the third largest bottler of Pepsi Co products. The taxpayers challenged a notice of deficiency. The taxpayer's expert David McCoy tax-affected G&J's cash flows on the income approach by 40 percent. The IRS expert, Dr. Bajaj didn't tax-affect the cash flows.



## Appraisals of S-Corps & Pass Thru Entities

Gross Case: The Tax Payer's arguments:

- ✓ Petitioner taxpayers cite that a willing buyer would have tax affected the cash flows -> using same modeling analysts have historically used.
- ✓ That tax-affecting cash flows for S Corps was the standard practice.
- ✓ IRS's own handbook at the time discuss tax affecting the cash flows for comparability purposes.
- ✓ This is the way the IRS had done it before.

IRS / Dr. Bajaj's arguments:

- ✓ Tax-affecting is using hypothetical / non existent taxes at the entity level
- ✓ Tax payers create S Corps to avoid this very tax and should be recognized for doing such in the valuations of these companies.
- ✓ Does not agree that tax-affecting was universally accepted methodology.



## Appraisals of S-Corps & Pass Thru Entities

Open MRI v. Kessler: Delaware Chancery Case: 2006

- Shareholder dispute with Fair Value analysis. Majority tax affected at 40% / Kessler's appraiser didn't tax affect.
- Vice Chancellor Strine disagreed with both sides and the rulings in prior S-Corp Tax Cases – Gross, Adams & Heck cases
- Calculated to treat S Corporate Shareholder as receiving the FULL benefits of untaxed dividends by equating after-tax return to the after-tax dividend to a C Corp shareholder.



# Vice Chancellor Strine's Analysis in Kessler

	C-Corp	S-Corp	S-Corp Valuation
Income before Tax	\$100	\$100	\$100
Corporate Tax Rate	40%		<b>29.4%</b>
Available Earnings	\$60	\$100	\$70.60
Dividend / Pers. Income Tax	15%	40%	15%
Total Post Tax Distributions	\$51	\$60	\$60



# Current S-Corp Valuation Theory & Take-Aways

	No Dividends are Paid		Dividend is paid by the S Corp only to cover the Shareholder tax burden		100% of Cash Flow paid as dividends	
	C Corp	S Corp	C Corp	S Corp	C Corp	S Corp
Pretax income	500,000	500,000	500,000	500,000	500,000	500,000
Corporate Level Income Tax: (35%)	(175,000)	-	(175,000)	-	(175,000)	-
<b>Net Income</b>	<b>325,000</b>	<b>500,000</b>	<b>325,000</b>	<b>500,000</b>	<b>325,000</b>	<b>500,000</b>
<b>Dividends Paid</b>	-	-	-	<b>175,000</b>	<b>325,000</b>	<b>500,000</b>
Cash flow retained by Company	325,000	500,000	325,000	325,000	-	-
<b>Stockholder Cash Flow</b>						
Dividends Paid	-	-	-	175,000	325,000	500,000
Personal Taxes Due						
C Corp Dividend 15%	-	-	-	-	(48,750)	-
S Corp Net Income 35%	-	(175,000)	-	(175,000)	-	(175,000)
<b>Net Cash Flow to Stockholder</b>	<b>-</b>	<b>(175,000)</b>	<b>-</b>	<b>-</b>	<b>276,250</b>	<b>325,000</b>
					<b>Difference</b>	<b>48,750</b> 18%

As a minority Shareholder this would be a bad investment

This is the earnings stream most likely to be used by an appraiser to determine FMV

Under this scenario, it appears the S Corp may be more valuable to the investor. The appraiser would evaluate dividend trends and an additional risk premium may need to reflect excess

A controlling shareholder could change the dividend policy.



## Current S-Corp Valuation Theory & Take-Aways

- The IRS is expecting to see some modified tax rate on S Corp appraisals. Some centers will mark on the appraisals “Didn’t employ an S Corp tax adjustment model” and send back with deficiency notice.
- Models now are more complicated based on historical payout ratios, capital retained in the business and an iterative process to arrive at an appropriate tax rate. Usually in the teens to low 20 percent range depending on variables.
- If your client has an S Corp in either a tax planning or litigation environment, please make sure the appraiser understands these current issues.



## Personal Goodwill v. Enterprise Goodwill

- The issue of Personal (aka Professional) goodwill versus enterprise goodwill comes up a lot with service companies, medical practices and other professional practices in divorce.
- It also comes up in certain S Corp election engagements (See Martin's Ice Cream case).
- The challenge is to articulate through the appraisal process a way of demonstrating an allocation of the FMV of a firm between the professional goodwill and the enterprise goodwill.
- Generally professional goodwill is already a part of that professional's take-home pay and therefore is already part of support and maintenance in the divorce. Whereas, Enterprise Goodwill is a divisible asset and is not subject to the concerns of "double dipping" in the family court.



## Practice Excess Earnings Model (PEEM)

- Multi Attribute Utility Model (MUM):
- Steps:
  - Compute Value or Excess Value of Goodwill of Practice
  - Allocate Goodwill between Personal and Enterprise Factors
  - Add % of Enterprise Goodwill to 100% of tangible assets
  - Compute Tangible assets value
- Strengths: PEEM & Mum factors have been accepted in several states (Illinois: Re Marriage of Alexander, for example).
- Weakness: It is a subjective analysis. To think otherwise is problematic to the expert witness on cross examination.



# Allocation Factors / (MUM Factors)

## Personal Goodwill Indicators

- Lack of Transferability
- Specialized Knowledge
- Personal Reputation
- Inbound Referrals
- Work Habits
- Closeness of Contact
- Ability

## Enterprise Goodwill Indicators

- Number of Offices
- Staff
- Repeat Revenue Stream
- Outbound Referrals
- Branding
- Business Reputation
- Business Location



# Practice Excess Earnings Model (PEEM) & MUM

PEEM  
Model:

Description	2005	2006	2007	2008	2009	5- Year Ave
Adjusted Earnings	\$350K	\$405K	\$433K	\$465K	\$505K	\$431.6K
Baseline Earnings(1)	\$285K	\$315K	\$340K	\$375K	\$415K	\$346K
Differential	\$65K	\$90K	\$93K	\$90K	\$90K	\$85.6

Capitalize  
PEEM

Excess Professional Earnings	\$85.6
Capitalization Rate – Based on WACC	24.0%
Gross Value of Goodwill	\$356,667

Allocate  
For  
MUM  
Factors

Factor	Weighting	Professional	Enterprise
Specific Knowledge	25%	\$89,166.75	
Trained Staff	20%		\$71,333.40
95% Annual Client Retention	15%		53,500.05
Multi-Location Business	15%		53,500.05
Practice Reputation	15%		53,500.05
Work Habits & Ability	10%	35,667.00	
Grand Total Allocation of Goodwill	100%	\$124,833.75	\$231,833.55



# Cases Cited

## DLOM Cases

- *McCord v. IRS* (120 T.C. No. 13)– On May 14, 2003
- *Clarissa W. Lappio v. Commissioner*, T.C. Memo 2003 – 258, September 3, 2003.
- *Estate of Kelley v. Commissioner*, T.C. Memo, 2005-235, October 11, 2005.
- *Litchfield v. Commissioner* T.C. Memo 2009-21, January 29, 2009

## Built-in Gains Cases

- *Eisenberg v. Commissioner* 155 F.3d 50 (2d Cir. 1998)
- *Estate of Davis v. Commissioner* 110 T.C. 530 (1998)
- *Estate of Dunn v. Commissioner* 301 F.3d 339 (5<sup>th</sup> Cir. 2002)
- *Estate of Jelke III v. Commissioner* 507 F.3d 1317 (11<sup>th</sup> Cir Court 2007)
- *Litchfield v. Commissioner* T.C. Memo 2009-21, January 29, 2009

## S Corp Tax Affect Cases

- *Walter L. Gross v. Commissioner*, T.C. Memo, 1999-254, Affd. 272 F 3d 333 6<sup>th</sup> Cir. 2001
- *Estate of William G. Adams, Jr. v. Commissioner*, T.C. Memo 2002-80
- *Estate of Richie C. Heck v. Commissioner*, T.C. Memo 2002-34
- *Delaware Open MRI Radiology Associates, PA v. Howard B. Kessler*, No. 275-N (Del Chan. 2006)

## Professional v. Enterprise Goodwill Cases

- *Martin Ice Cream Co. v. Commissioner* (110 TC 189 (1998)
- *In re Marriage of Talty* 166 Ill 2d 232, 652 N.E. 2d 330 (1995)
- *In re Marriage of Alexander* 368 Ill.App. 3d 192, 195, 857 NE 2d 766 (5<sup>th</sup> Dist. 2006)