Valuation Concepts

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summer 2005

The sum of the parts isn't always equal to the whole

The valuation swing vote

The term "swing vote" refers to a situation in which a minority ownership, when combined with another minority ownership, forms a voting block sufficient to exert control over a business. Typically the concept is used in a business valuation in the context of discounts and premiums.

What is the "swing vote"?

Discounts and premiums are adjustments to the business value that are necessary to account for specific ownership characteristics of a particular investment.

One of the most common adjustments is the discount for lack of control. The *International Glossary of Business Valuation Terms* defines this discount as "an amount or percentage deducted from the pro-rata share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control." A minority interest in a business affords an investor little or no rights or powers and a valuation of a fractional ownership interest results in a scenario in which the sum of its parts isn't always equal to the whole.

The swing vote attributes are considered in choosing the appropriate discount for lack of control. In the case of a 51% shareholder and a 49% shareholder, the 49% shareholder has very limited control of overall direction of the company, unless an operating agreement or bylaws say otherwise. Without a relevant operating agreement or bylaws, the 49% block of shares is likely to be discounted for lack of control.

A classic example of the swing vote is illustrated by a situation with two 49% shareholders and one 2% shareholder. Each of the 49% shareholders would likely be willing to pay a substantial premium over the 2% pro-rata company value to obtain the benefits associated with a controlling ownership interest. Once the additional 2% block of shares is acquired, the 51% ownership interest would no longer be adjusted to reflect the discount for lack of control.

What does the IRS say?

But in the real world, the above-described example rarely happens. In fact, the issue of the swing vote is most often encountered in the gift and estate arenas.

Before Revenue Ruling 93-12 (issued in 1993), the IRS had maintained that the discount for lack of control did not apply to situations where family members owned minority interests because of

the "family attribution theory." This theory states that the family ownership should be considered as one voting unit and assumed to act in unison. The IRS argued that the minority interests should be valued based on their pro-rata of the 100% value of the business. After suffering multiple tax court defeats, the IRS finally acquiesced on its position in Revenue Ruling 93-12.

However, in IRS Technical Advice Memorandum 9436005, which came out in May 1994, the IRS asserted that a swing vote may mitigate the minority discount or offset the marketability discount.

What do the courts say?

In the case *Estate of Richard R. Simplot v. Commissioner*, the Tax Court assigned a substantial premium to the decedent's minority voting stock over his nonvoting stock. In its analysis, the Tax Court considered who would be the most likely buyer, the investment holding period and the potential control ownership implications, among other things.

On appeal, the Ninth Circuit reversed the Tax Court's decision, finding it was based on "speculation" and "imaginary scenarios." The court implied that the application of a strict hypothetical buyer-seller standard, as depicted in Revenue Ruling 59-60, prevents the IRS from using its swing vote argument to assign a control premium and to deny a minority discount based on "imaginary scenarios." The Ninth Circuit stated that a hypothetical willing buyer and a hypothetical willing seller are not "specific individuals or entities."

Concept of swing vote meets court challenge

In *Estate of True v. Commissioner,* the IRS claimed that the minority interests owned by Dave True (the decedent) were not entitled to a minority discount because they represented significant ownership blocks that had swing vote potential. The IRS maintained that, because True held the largest single block of voting rights in each of the entities in question, his block could be combined with any other single block to effectively gain control in each of the entities.

The Tax Court rejected the IRS's position. In evaluating whether a minority discount should be applied, the court assumed that the hypothetical buyer of True's interest would be an unrelated party, rather than a member of his family. According to the court, "We find it unlikely that a member of Dave True's family would join forces with an unrelated purchaser to gain control." The court also noted that, in the case of general partnerships that are jointly managed by all owners, the concept of voting control does not apply.

Is the swing vote still a valid concept?

The swing vote and its effect on value should be considered and analyzed based on the specific facts and circumstances surrounding a particular valuation. In cases where the swing vote concept could exist, valuation reports are more likely to withstand a challenge on a stand-alone basis if the swing vote is specifically addressed within the report.

Timing is everything

Interim financial statements can be useful in determining value

A valuation analyst uses a company's financial statements to analyze its historical financial performance over time and gauge its performance against those of its industry peers. The statements also help the expert determine questions to ask management and valuation approaches to use.

Often companies are valued at their fiscal year end. This generally makes the data gathering process straightforward because financial statements are usually prepared as of the year end date and will have already been audited, reviewed or compiled by a CPA.

Sometimes, however, it's necessary to value an entity *during* its fiscal year, requiring the analyst to request interim financial statements. These statements can be particularly useful when a company is emerging from an upward or downward trend in its financial performance or when current financial performance is materially different from what has been reported historically.

Boost or bane to value

Assume a company historically has manufactured two products and always has broken even. Now management makes a change in corporate philosophy and decides to abandon one of the products as of their year end Dec. 31. As a result, starting Sept. 30, while revenues are down, gross profit and operating income are higher than they have been in years. This may signify a

new positive trend, which may be important to consider in the valuation.

A review of interim statements also can reveal items that may negatively affect an opinion of value. For instance, unusually high professional fees may mean pending litigation could have a material effect on operations, profitability and value. Or the loss of a key vendor and switch to a higher-priced one after fiscal year end could mean significantly lower gross profits than in years past. If this continues, it could affect value.

Factors to consider

There are other issues the analyst also considers. First, he or she looks at the proximity of the valuation date to the company's fiscal year end. For example, if the valuation date is Jan. 31 and the fiscal year end is Dec. 31, it is necessary to interview management to determine whether any activity that might have a material effect on the value of the business took place between the valuation date and the financial statement date.

Second, the analyst evaluates the quality of the interim statements. Many accounting principles or year end adjustments that are addressed in year end statements may not be accounted for in interim financials. This may severely impact their comparability with the annual statements.

Third, the analyst considers whether the company's operations are seasonal, which may impact the usefulness of interim financials. For instance, in valuing a toy store that earns the majority of its revenue in the last quarter, interim statements as of March 31 may not prove valuable.

These statements can be particularly useful when a company is emerging from an upward or downward trend in its financial performance.

Finally, analysts often find it worthwhile to examine the 12 months preceding the interim statement. This can highlight the ups and downs of the fiscal year, such as the seasonality of revenues or certain expenses. Requesting interim statements for the same time period in the previous fiscal year can enhance comparability and validation of certain trends.

Reaching the value conclusion

The need for a company's value doesn't always coincide with the fiscal year end. In such situations, interim financial statements may help the valuation professional recognize trends and determine the financial condition, both historically and going forward. This, in turn, will assist in arriving at the value conclusion.

Irreplaceable assets: When key-person discounts apply

Valuation professionals sometimes apply nontraditional risk discounts beyond the commonly used minority and marketability discounts. The key-person discount, for example, reflects the fact that the loss of an owner or vital manager could have dire effects on the business's ability to generate cash and therefore reduce the amount investors might be willing to pay for a share of the company.

Different approaches

Sometimes valuators factor key-person discounts in their marketability discount or capitalization rates. At other times, they apply a separate key-person discount to their preliminary value conclusion, with the application at the discretion of the valuator. A key-person discount doesn't apply to every small or midsize company and, generally, this discount type is significantly lower than marketability or minority discounts. But several factors indicate when it may be applicable.

In accordance with Revenue Ruling 59-60 (RR 59-60), valuators consider two main factors when calculating a key-person discount: 1) the effect that losing a key person would have on the company's future expectancy, and 2) the absence of viable management successors.

Business expectancy

Valuators consider business expectancy factors by looking at the business and its industry. One of the most important business characteristics that support a key-person discount is its management structure — when one person, for example, exclusively manages a company.

Valuators look carefully at a company's owners and managers when considering whether to apply a key-person discount.

In addition, the more sensitive a company's operations have historically been to changes, the more likely the company is to incur substantial financial declines with the loss of a key person. The complexity of the company's operations will also affect the key discount. If one individual possesses the knowledge needed to operate in a complex environment, a key-person discount should be applied.

Finally, a reliance on government contracts is a factor. Some government contracts are awarded to companies because at least 51% of their owners are certified by the Small Business Administration to be "socially and economically disadvantaged." If the loss of a key person would cause a company to lose government work, a key-person discount may apply.

Potential successors

Valuators look carefully at a company's owners and managers when considering whether to apply a key-person discount, including the following:

- How closely each individual is involved in strategic decisions,
- Each individual's unique professional experience or industry expertise,

- How each individual's reputation in the industry or community drives business, and
- Each individual's strong relationships with customers or suppliers.

Valuators also look for personal guarantees key people have made for business loans. The loss of those people might force the company to pay higher interest to maintain its loan or, alternately, the bank might refuse to extend credit.

Other factors

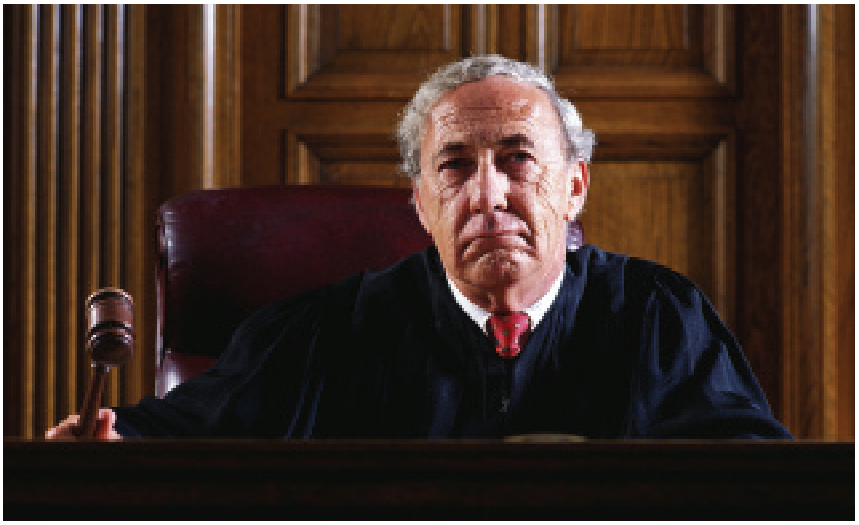
Valuators also look for other issues that may reduce or eliminate a key-person discount. For example, life or disability insurance proceeds can protect a company should a key person die or become disabled. The existence of noncompete agreements similarly protects an organization from a key person who might leave and then compete against it.

Valuation professionals may further estimate a key-person discount in part by quantifying the cost to replace the employee. But the key person's salary should offset this replacement cost, net of any continuing obligations, because the company will not incur that cost in the future.

Indispensable tool

For many companies, success largely depends on the leadership and expertise of one or a few individuals. The key-person discount can help determine the effect an individual has on the amount investors might be willing to pay for a share of the company.

IRS continues its attack on FLPs



Family limited partnerships (FLPs) are useful vehicles for managing assets and transferring them to family members. FLPs are especially attractive since they allow older family members to make orderly transfers of assets to younger family members while retaining control over the management of the assets. For example, it can be difficult to divide real estate among children and other loved ones. But real estate can be transferred to an FLP and partnership interests can be gifted to family members.

An FLP offers other benefits as well. The donor can maintain control over the assets as general partner, protect against creditors, avoid fractionalization of the title, take advantage of economies of scale and diversification of opportunities, and keep assets in the family. But there are two other potential benefits that have prompted the IRS to attack FLPs: 1) valuation discounts on gifts of the limited partnership interests, and 2) the exclusion of gifted FLP interests from the donor's taxable estate.

The basis for attack

FLPs cannot be created solely for the purpose of reducing taxes. If the IRS can prove there are no business, investment or income-producing reasons for an FLP to exist, the partnership in whole or in part can be disregarded, partners can be treated as nonpartners, tax items may be reallocated among partners, or claimed tax treatments may be adjusted or modified.

Some of the common areas of attack revolve around IRC Sections 2703, 2704(b) and 2036(b). Sec. 2703 and 2704(b) were enacted to abolish perceived valuation abuses in asset transfers among family members. Sec. 2036 provides that, if an individual transfers stock in a privately held company and retains, directly or indirectly, the right to vote the shares, the stock will be included in the donor's gross estate at the date of death.

Sec. 2703 and buy-sell agreements

Sec. 2703 generally requires the fair market value of property to be transferred without discounts related to options, agreements or any other restrictions on the right to sell or use the property. But this rule does not apply if the restriction:

- Is a bona fide business arrangement,
- Is *not* a device to transfer property to members of the decedent's family for less than full and adequate consideration, and
- Has terms comparable to similar arrangements entered into by persons in arm's length transactions at the time the restriction or agreement is created.

If the partnership agreement documents the good health of the general partner and reasons for forming the FLP related to a trade or business, investment or income-producing venture, it may strengthen the position that the FLP is not a wealth transfer device.

On the other hand, if an FLP is formed while a general partner is terminally ill, he or she dies within a short period of time, and transfers of limited partnership interests immediately follow, the IRS may claim the transaction was in reality a device to transfer property to family members without a bona fide business purpose and for less than full and adequate consideration.

In addition, when an FLP valuation is determined from only an asset-based approach, the IRS has argued to disregard the partnership agreements. The IRS has claimed that discounts are justified solely on the restrictions in the partnership agreement, without comparison to terms in similar arm's length transactions.

This argument has not yet been proven in Tax Court. But the IRS has used it successfully to negotiate with taxpayers for an increase in the amount of gift and estate taxes that would otherwise have been paid. By using the income and market approaches and supporting the selection of discounts, a valuation can be more easily supported and will more likely withstand IRS and Tax Court scrutiny.

"Default" provisions

Sec. 2704(b) provides that, to the extent the rights of partners in FLPs are covered by state law "default" provisions, any restrictions on the rights of the partners greater than those imposed by state law will be disregarded in the valuation process for transfer tax purposes. The Revised Uniform Limited Partnership Act (RULPA) (adopted in some form by all states except Louisiana) has default provisions that allow limited partners to withdraw by giving six months' notice.

Recently, the IRS has taken the position that any provision in a partnership agreement that restricts withdrawal rights beyond the RULPA default provisions should be ignored for transfer tax purposes. Providing a fixed duration or term of years for a partnership agreement may prevent the limited partners from being able to "cash out" on six months' notice, and preserve FLP gift tax benefits.

Sec. 2036(b) and privately held companies

There is still debate about whether Sec. 2036(b) applies when stock in a privately held company is contributed to an FLP and the general partner retains voting control of the stock. The IRS contends that the FLP may be merely a testamentary vehicle employed to shift assets to future generations.

A company may be able to avoid attack by recapitalizing and issuing voting and nonvoting stock before an owner funds the FLP. The owner can fund the partnership with the nonvoting stock. If the partnership agreement states that all partners can vote the stock in accordance with their partnership interests, only the donor's pro rata share of the stock will be at risk under Sec. 2036.

Avoiding compliance issues

To prevent these types of IRS attacks, any partnership provisions that would not be acceptable in a commercial transaction between unrelated parties acting in their own self-interest should be avoided. The use of FLPs must be real, multipurposed and supported by the appropriate documentation and operational monitoring support.

Each situation is unique; generally, however, general partners should not retain exclusive management powers, absolute control over distribution or the power to restrict the limited partners' ability to transfer their interests. The FLP's general partners also must strictly adhere to the provisions of its operating agreement. A team including an estate planning attorney, valuation expert and CPA can advise them in complying with IRS rules and avoiding potentially adverse effects. <>