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Valuation Concepts

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A lesson in deferred tax

When the Financial Accounting Standards Board (FASB) adopted Standard No. 109 (*Accounting for Income Taxes*) in the early 1990s, deferred taxes were widely covered in the financial news. But in recent years, few periodicals have published articles on this topic. Valuation professionals, however, can't afford to lose sight of deferred taxes, because they can materially affect a company's value.

What are deferred taxes?

Companies pay income tax on IRS-defined taxable income. On their generally accepted accounting principles (GAAP) financial statements, however, firms record income tax expense based on accounting "pretax net income." In a given year, taxable income and pretax net income may substantially differ. A common reason for this temporary difference is depreciation expense.

For income taxes, the IRS allows companies to use accelerated depreciation methods to lower the taxes paid in the early years of an asset's useful life. Alternatively, companies frequently use straight-line depreciation for GAAP reporting purposes. As the asset ages, the temporary difference in depreciation expense reverses itself.

If a company's pretax net income and its taxable income differ, it must record deferred taxes on its balance sheet. The company records a deferred tax asset for the future benefit it will receive if it pays the IRS more tax than an income statement reflects. If the opposite is true, the company records a deferred tax liability for the additional future amount it will owe.

These temporary reporting method differences are not the only reason companies record deferred tax liabilities. Deferred tax assets may occur from three other sources: capital loss carryforwards, operating loss carryforwards and tax credit carryforwards.

Like other assets and liabilities, deferred taxes are classified as either current or long-term. Regardless of their classification, deferred taxes are recorded at their cash value (that is, no consideration of the time value of money). Deferred taxes are also based on current income tax rates. If tax rates change, the company revises its balance sheet and the change flows through to its income statement.

While deferred tax liabilities are recorded at their full amount, deferred tax assets are offset by a valuation allowance that reflects the possibility the asset will expire before the

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Understanding normalizing adjustments

Disagreements may develop when a valuator makes adjustments to generally accepted accounting principles (GAAP) financial statements. Are the modifications reasonable and necessary? Did the appraiser consider all relevant items in his or her adjustments?

One category of financial statement alteration called "normalizing adjustments" is designed to allow meaningful comparisons between a company's past and future performance. That in turn enables financial experts to compose meaningful value conclusions.

Establishing financial harmony

When a valuator makes normalizing adjustments, he or she typically converts GAAP net income to normalized earnings. *The International Glossary of Business Valuation Terms* defines normalized earnings as "economic benefits adjusted for nonrecurring, noneconomic, or other unusual items to eliminate anomalies and/or facilitate comparisons."

Normalizing adjustments may be essential when valuing a company. These modifications help valuators compare the subject company's operations to its competitors', forecast the company's future cash flows, and modify the earnings of comparables used in the market approach.

Performing normalizing adjustments

Normalizing adjustments require a valuator to use his or her judgment. It is often difficult for non-valuation professionals to understand valuation adjustments. To clarify matters, normalizing adjustments can be grouped into three categories:

Odd accounting conventions. Many accounting conventions don't make sense from a valuator's perspective. For example, accountants match expenses to the revenues for which they were incurred; therefore, when a customer pays upfront for a three-year magazine subscription, the publisher gradually records the income over a three-year period. When projecting the magazine publisher's future cash flows for valuation purposes, however, the actual timing of cash flows may be more important than the matching principle, because of the time value of money.

Depreciation expense is another common normalizing adjustment that brings accounting conventions in line with economic reality. Some private companies use accelerated tax depreciation methods for both book and income tax reporting. These accelerated methods minimize a company's tax liability. But they also understate future cash flows if the valuator uses the company's depreciation expense to approximate its future capital needs.

Atypical industry norms. Some industries have unique accounting habits that industry participants often apply inconsistently. Many law firms, for instance, use a hybrid of revenue recognition that combines elements of cash and accrual accounting.

When making normalizing adjustments, a valuator typically converts GAAP net income to normalized earnings.

To illustrate, some law firms report no receivables; others record receivables only for reimbursable expenses the firms paid on behalf of their clients. Furthermore, because many law firms bill only at month-end, reported receivables likely are underestimated by unrecorded outstanding contingency cases and unbilled work-in-progress. Consequently, when valuing a law firm, the professional valuator must consider the industry's financial reporting oddities.

Unusual and nonrecurring items. Most normalizing adjustments fall into this category. If a company earns income or incurs expenses that are unusual and not expected to recur, the valuator may need to eliminate these items.

When adjusting for these items, it's important that the valuator look beyond the narrow GAAP definitions of "extraordinary," "unusual" and "nonrecurring." Common examples of unusual and nonrecurring adjustments include changes of accounting methods, discontinued operations, insurance proceeds, lawsuit expenses and settlements, gains or losses on asset sales, and the effects of a strike or act of God.

A valuation expert may also consider the adequacy of the company's working capital and reserve accounts, such as its allowances for bad debts, pensions and deferred maintenance.

Explaining adjustments

When a valuator makes normalizing adjustments, certain clients and related parties may object. Valuation professionals generally should provide detailed explanations of their adjustments and, whenever possible, support them with authoritative references, thus greatly minimizing potential confusion and arguments between the parties.

Remember, too, this article is brief and normalizing adjustments are just the tip of the iceberg. Valuation professionals can legitimately modify some of a company's financial results — in ways not covered here. Other types of adjustments include control adjustments, nonoperating asset addbacks and valuation discounts. <>

Recent case law trend suggests a balance between control and valuation discounts

Much to the dismay of taxpayers and their attorneys, the IRS has finally managed to score some courtroom victories against family limited partnerships (FLPs). FLPs will, however, continue to offer taxpayers numerous benefits — including sizable valuation discounts — for years to come if taxpayers and their advisors learn the lessons taught by these recent legal battles.

Too good to be true

FLPs gained popularity in the 1990s for the numerous benefits they offer wealthy individuals. With an FLP, a donor can transfer a substantial chunk of his or her wealth to heirs, charitable organizations or both at a discount from the partnership's net asset value. As an added bonus, donors don't have to relinquish complete control to their heirs, as long as they retain a small general partner interest in the FLP. The major downside is the FLPs' administrative hassle and expense.

Generally, to maximize an FLP's minority interest and marketability discounts, an attorney drafts the partnership agreement to maximize general partner control and minimize limited partners' rights. Then, when justifying his or her valuation discounts, the valuation expert cites the FLP's numerous restrictive provisions.

Several recent cases, however, suggest that attorneys can take this strategy too far. In fact, restrictive provisions in which a donor retains control or enjoyment of the underlying assets could prove to be his or her undoing — serving to eliminate valuation discounts altogether.

Taxpayer rudely awakened

After repeatedly failing to defeat FLPs using Chapter 14-based claims, the IRS revised its modus operandi. Under its new attack plan, the IRS challenges FLPs under Section 2036(a) of the Internal Revenue Code covering situations in which the donor explicitly or *implicitly* retains control of, and an ongoing benefit from, the partnership's assets.

When justifying his or her valuation discounts, the valuation expert cites the FLP's numerous restrictive provisions.

In a number of highly publicized cases — including *Strangi*, *Harper* and *Thompson* — the IRS has made significant inroads against the steep discounts from which FLPs have historically benefited.

Estate of Albert Strangi v. Commissioner (T.C. Memo 2003-145). The IRS scored a substantial victory against FLPs last spring when the Fifth Circuit remanded *Strangi* to the lower court for consideration of the IRS's last-minute Section 2036(a) contention. On remand, the Tax Court ruled in the IRS's favor, leaving the estate to pay tax on the partnership's net asset value of $11 million, rather than the discounted value of approximately $6.6 million claimed on the estate's tax return.

Even though the Strangi estate apparently tried to abide by the rules set forth in its partnership agreement, the decedent died within a year of the FLP's creation, which raised a red flag with the IRS. Other signs that Strangi's partnership blatantly violated Section 2036(a) include the decedent's use of a personal residence owned by the FLP and the contribution of 98% of his assets to the partnership, which left him without enough cash to support himself.

The Tax Court concluded that "the crucial characteristic [in *Strangi*] is that virtually nothing beyond formal title changed in decedent's relationship to his assets."

Estate of Morton B. Harper v. Commissioner (T.C. Memo 2002-121). The IRS not only attacked valuation discounts taken on Harper's estate tax return but also on gifts the decedent made to his children prior to his death. This case sets forth an insightful list of factors the judge considered when deciding to disallow the FLP valuation discounts under Section 2036(a).

Admittedly, Harper's partnership committed some blatant abuses of the Internal Revenue Code, such as disproportionate distributions and commingled personal and partnership assets and expenses. The FLP also committed less obvious indiscretions, including distributions that corresponded to the decedent's living expenses and gifts, as well as the decedent's unilateral control of the partnership.

Estate of Theodore Thompson v. Commissioner (T.C. Memo 2002-246). Once again, the Tax Court disallowed valuation discounts in the *Estate of Thompson*. Not only had the donor transferred the bulk of his assets to the estate's FLP, but the partnership also paid Thompson distributions to fund his assisted living expenses and annual gifts. The court dubbed Thompson's transfers to the FLP "a mere recycling of value."

When creating partnership agreements, these recent cases suggest a fine line between restricting limited partners' rights and retaining donors' control and economic benefits from the partnerships. While these restrictions may serve to support above-average FLP valuation discounts, if taken too far they can negate the effect of any discounts whatsoever.

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company can use it. Deciding how much deferred tax valuation allowance to book is highly subjective and left to company management's discretion. In fact, some executives may use these allowances to manipulate profits, because any changes to the allowance flow through to the company's income statement.

How do valuators calculate deferred taxes?

Deferred taxes are confusing and subject to GAAP rules, which often differ from real-life economics. Unlike accountants, valuation professionals generally view deferred taxes from the perspective of a company's potential buyers and sellers.

A company that offers buyers significant tax savings later could be worth more than an identical business without deferred tax assets, and vice versa. Key issues are whether the deferred taxes are transferable to new owners, and the extent to which ownership changes may affect the realization of tax deferrals.

Balance sheet considerations. When the balance sheet is used to derive a company's value, the valuation expert may address deferred tax assets and liabilities in a variety of ways. For instance, he or she may adjust the recorded cash values to their net realizable values using the company's cost of capital. The valuation professional might also address any anticipated tax rate hikes or cuts.

Cash flow considerations. Deferred taxes also affect the income statement and, ultimately, the company's cash flows. Depending on the situation, historical income statements may receive normalizing adjustments for deferred tax items, such as annual changes to the deferred tax valuation allowance, that make their way to the company's bottom line.

Deciding how much deferred tax valuation allowance to book is highly subjective and left to company management's discretion.

When making cash flow projections, the company's effective tax rate could be raised or lowered to reflect deferred tax liabilities or assets, respectively. Or the valuator might employ a discounted cash flow analysis to reflect the projected timing of deferred tax recognition.

Alternatively, the company might estimate the net realizable value of tax deferrals and add this estimate to its preliminary value conclusion, much like the treatment of a nonoperating asset or liability.