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Management overlay must be factored into valuation of an affiliated entity

Milo Fields Trust v. Britz, 2005 N.J. Super. LEXIS 176 (App. Div. June 9, 2005). Judge Holston.

Facts

Milo Fields Trust owned minority interests in two limited liability companies (LLCs), **PMB of Hackensack, L.L.C.** and **PMB of Union City, L.L.C.** Gary Fields (Fields) was trustee. These LLCs, along with others like them, had been formed by Jeffrey Britz, who, along with his wife, owned 100% of **Professional Management Bureau, Inc.** (PMB), which managed all the LLCs' business affairs.

In anticipation of the sale of Britz's interest in the LLCs and the sale of the assets of PMB to **Select Medical of New Jersey** (Select), Britz offered the trust, through Fields, $ 191,000 for the trust's interest in both LLCs. Britz had previously returned Fields' initial combined investment of $31,280 in both LLCs and an additional $ 19,000 in profits to Fields. Fields, acting for the trust, refused the offer. The sale by Britz to Select was consummated and **Select Management Services, L.L.C.** (SMS) was formed. No distributions were made to the trust after the sale, and the trust brought suit for, among other things, breach of fiduciary duties, breach of contract, fraud, and misappropriation.

Valuation evidence

At trial, the judge valued the trust's interest in PMB of Hackensack and PMB of Union City at $ 170,000 plus interest. As to valuation, the judge determined that the formula for arriving at the Select transaction purchase price (five times the adjusted earnings of the active clinics): created the illusion that the only "things" of value that entered into the value of the package were the LLCs themselves and that the relative values of the LLCs could be derived simply by a mathematical application of the price proportionately to the constituent LLCs. And it created the illusion that the value of minority shares in the two LLCs with minority interests could be derived arithmetically as well. However, the judge concluded "that there was much more to the transaction than the LLCs alone" including "the overlay of PMB and its management of the clinics" and Britz'[s] employment agreement that contained the non-competition provision.

The judge rejected the opinion of **Henry Fuentes**, plaintiff's accounting expert, because Fuentes "omitted the obvious value of the PMB element of the transaction." The judge accepted the opinion of **Gary Trugman**, defendants' accounting expert, because Trugman allocated "the price paid by Select to the interests of the LLC owners by first determining and then subtracting from the price the value of PMB" and that Trugman "demonstrated that the value of PMB could be established." According to the judge, Trugman estimated the "resulting value of Fields' interest at $ 159,961, or a then present value of $ 148,540," and that Trugman came up with an alternate valuation of $ 192,097, which omitted a component involving estimated compensation to Britz.

The judge valued the trust's interest at $ 170,000 by taking the average of two valuations expressed by Trugman ($ 148,540 + $ 192,097) "rounded." The court further held that

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the judgment in favor of the trust "subsumes all claims and theories advanced in plaintiff's complaint" and "all of the legal theories of this case have merged into simply a determination of the value of plaintiff's minority interest in the LLCs that were essentially dissolved in the … transaction."

Holding

The appellate court found that the lower court's approach to the valuation was acceptable and supported by substantial evidence, and, accordingly, affirmed the lower court's decision.

Analysis leads chancery court to seek its own valuation

***In re U.S. Cellular,* 2005 Del Ch. LEXIS 1 (January 6, 2005).** *Judge Parsons.*

The issue in this appraisal action was the value of the shares of two cellular companies (Janesville and Sheboygan). **US Cellular Operating Company** (USCOC) merged the two companies into itself. Prior to the merger USCOC owned over 90 percent of the shares of each company.

The valuation date was set as October 31, 2000. One year prior, USCOC engaged **Duff & Phelps**, an independent valuation firm, to appraise both companies. During that appraisal, Duff & Phelps, "analyzed the companies' historical financial results, budgets, bylaws and market information. [Duff & Phelps] also interviewed management and collected additional information where needed." As a result of that valuation, Janesville was valued at $42.57 per share and Sheboygan was valued at $19.69 per share. USCOC did not proceed with the merger at that time.

In August 2000, USCOC asked Duff & Phelps to re-value the two companies. During the valuation, the financial performance figures were updated and the appraisers spoke with management about operations and of the companies current outlook.

On September 13, 2000, Duff & Phelps issued an opinion that valued Janesville at $43.85 per share and Sheboygan at $21.45 per share. The valuation included a discounted cash flow (DCF) analysis and a comparable transaction approach. The court noted that there was no evidence to suggest the USCOC gave the appraisers any "target" numbers. The merger commenced on October 31, 2000, and the dissenting shareholders sought this appraisal action.

Valuation evidence

The dissenting shareholders presented the expert testimony of **Richard C. Harris, CPA**. Harris utilized both the DCF method and the comparable transaction method. The results of these methodologies were within 10 percent of each other, so he weighted them equally. This resulted in a fair value of $72.89 per share for Janesville and $41.39 per share for Sheboygan.

USCOC employed **John S. Sanders, MBA** as their expert. Sanders testified that he began by researching the current state of the cellular markets as well as researching other various relevant demographics. Sanders also utilized both the DCF method and the comparable transaction method. His DCF resulted in values of $45.11 and $22.05 per share for Janesville and Sheboygan, respectively. He then used the comparable transaction method as a reasonableness check.

Holding and rationale

The Court concluded that neither valuation was sufficient and thus took it upon its self to value the companies. Using the DCF method, the court arrived at $57.14 as the per-share value for Janesville and $28.25 as the per-share value of Sheboygan. The court then employed the comparable transaction method, which yielded $46.67 per share for Janesville and $34.52 per share for Sheboygan. The court gave the DCF method a 70 percent weighted average with the comparable transaction method receiving 30 percent. This resulted in a value for Janesville of $54.00 per share and a value of $30.13 per share for Sheboygan.

Transfers of stock to business trusts not included in decedent's gross estate

Estate of Schutt v. Commissioner, T.C. Memo 2005-126; 2005 Tax Ct. Memo LEXIS 126 (May 26, 2005). Judge Wherry.

Schutt, I, Business Trust (Schutt I) and Schutt, II, Business Trust (Schutt II), both Delaware business trusts, were formed in 1998. The trusts were capitalized by the contribution thereto of stock by **Charles Porter Schutt** (decedent) through a revocable trust and by **Wilmington Trust Company** (WTC) as trustee of various trusts created for the benefit of decedent's children and grandchildren. At his death in 1999, decedent held through the revocable trust a 45.236 percent interest in Schutt

I and a 47.336 percent interest in Schutt II.

As of the valuation date, the underlying asset value of Schutt I was $65,273,495, of which the revocable trust's proportionate share was $29,527,314. The underlying asset value of Schutt II was $28,504,626, of which the revocable trust's proportionate share was $13,493,064. The value reported for the gross estate was $61,590,355.08, which included $15,837,295.45 and $7,237,104.56 for the revocable trust's interests in Schutt I and Schutt II, respectively.

The IRS issued a notice of deficiency, determining that the discounts applied in valuing the interests in Schutt I and Schutt II were excessive. The IRS also asserted that the full market value of the underlying assets contributed by the revocable trust to Schutt I and Schutt II should be included in decedent's gross estate under IRC Sections 2036(a) and 2038.

Holding and rationale

The Tax Court held that the transfers of stock to Schutt I and Schutt II were bona fide sales for adequate and full consideration within the meaning of Sections 2036(a) and 2038, such that the value of the transferred assets did not have to be included in decedent's gross estate under these statutes.

Transfers made for non-tax reasons

A key finding by the court was that decedent's transfer was made for other than estate tax advantage, namely, to ensure the perpetuation of decedent's "buy and hold" investment philosophy for the purpose of protecting his family's wealth. The court also found significant that by using the business trusts, decedent was able to apply this philosophy to the stock of the WTC trusts. Decedent's motives were well-documented by his estate planning advisers.

Despite this evidence of decedent's motives, the IRS maintained that tax savings through valuation discounts constituted the dominant reason for formation of Schutt I and II. The IRS characterized the issue of valuation discounts as having "dominated" the early discussions concerning the formation of a new entity. The IRS also noted that decedent and his advisers initially contemplated only transferring stock from the revocable trust to a business trust, and emphasized that the subsequent decision to involve the WTC trusts served a tax purpose of making available minority as well as marketability discounts.

The court rejected these assertions, finding that although it was clear that estate tax implications were recognized and considered in the initial stages of the planning process, the record failed to reflect that such issues predominated in decedent's thinking and desires. What may have originally been approached as a relatively routine estate planning transaction, rapidly developed into an opportunity and vehicle for addressing decedent's more fundamental concerns.

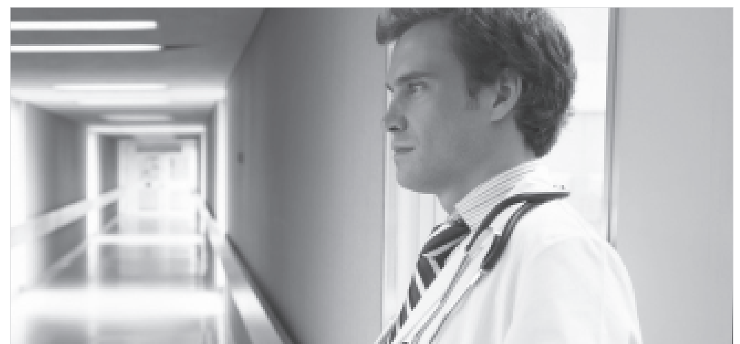
Bona fide sale

Finally, the court also determined that other factors indicative of a bona fide sale were that the contributed property was actually transferred to Schutt I and II in a timely manner; that entity and personal assets were not commingled; that decedent was not financially dependent on distributions from Schutt I and II, retaining sufficient assets outside of the business trusts amply to support his needs and lifestyle; and that decedent did not effectively stand on both sides of the transactions.

Adequate consideration

Given these circumstances, the court also held that the discounted value attributable to entity interest valuation principles was not per se to be equated with inadequate consideration, and rejected the IRS's contention that the transactions featured prohibited value recycling. The key here, the court reasoned, was that others contributed more than half of the property funding the entities, and that, therefore, decedent was not merely recycling his shareholdings.

Comment: *As in other cases where the IRS has sought to use IRC Section 2036 to include the value of an entity's underlying assets in a decedent's gross estate, this case demonstrates the need for good documentation that estate tax reduction through discounts is not the primary motive for the transaction. This case also teaches that in certain situations, business trusts, if properly structured, may be used as alternatives to FLPs where it is foreseeable that the IRS may invoke Section 2036.*



Husband's earlier sale valuation damages his later divorce valuation

***Gardner v. Gardner,* 2005 Va. App. LEXIS 10 (January, 2005).** *Judge Frank.*

At issue in this marital dissolution appeal was the value of husband's medical practice.

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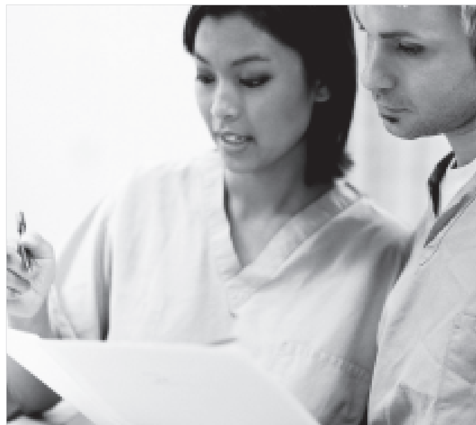
Valuation evidence

Husband presented the testimony of **Robert Pulliam, CPA, ABV** who concluded after using the net asset value method, that the value of the practice was $27,000. The court summarized Pulliam's testimony:



Pulliam rejected an excess earnings analysis, which is 'based on how much income is generated over and above a fair return on assets.' The 'excess' return is used in determining the goodwill portion of a practice's value. Pulliam concluded there were 'no excess earnings to capitalize and therefore implies that there was no goodwill within the practice.' Pulliam concluded that under this method of valuation the practice had no value.

Pulliam considered the direct market data method and arrived at a $13,000 value. Pulliam then concluded that the value of the practice should be 25% of annualized revenues less any debts.

Prior to the trial, the husband had employed **Thomas H. Hicok, CPA** to value the practice in anticipation of a possible sale. Hicok did not testify during the trial but his report was admitted into evidence. Hicok valued the practice using the capitalization of excess earnings method and the IRS formula method. This resulted in a fair market value of $195,016. Hicok determined there were excess earnings and valued them at $159,152 under the capitalization of excess earnings method and $230,879 under the IRS formula method.

Pulliam attempted to discredit Hicok's report, stating that it was full of accounting errors and that it was simply a negotiating tool.

Holding and rationale

The trial court valued the practice at $125,000. Because the trial court did not explain the basis of its conclusion, the appeals court had to examine the evidence to determine if it supported the trial court's ruling. The appeals court set the standard of value as "intrinsic" value. The appeals court concluded that the trial court's selection of a value between the experts' figures was acceptable.

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