

## Court's mixed message on 'sufficient and credible' financial evidence

*Hugh v. Hugh, 2014 Va. App. LEXIS 222 (June 3, 2014)*

What quantity and quality of evidence does a trial court need to make a meaningful valuation of a business? This was the central question in a hard-fought divorce proceeding that featured questionable financial records, problematic expert testimony, and highly polarized value determinations.

**'Scant' information:** The husband owned a business whose exact nature was a mystery. He seemed to be a broker for the semiconductor industry and regularly dissolved companies and reincorporated them under a slightly different name. He was the 100 percent owner of the current incarnation. At trial, the husband testified that he did business "everywhere" and that the company had no inventory at that moment. Tax returns related to the predecessor company and the current business showed a massive decrease in income from 2010 to 2012. He said that the company's recent poor performance was the result of "the bad economy" and "the semiconductor business was not doing well at all." Also, "I was not in a situation to run the business," he added. He concluded the company was worth zero. The wife hired an expert who reviewed the company's website, certain corporate documents, tax returns, financial statements and deposition statements that the husband and his CPA gave. The wife's expert said he received "scant" information from the husband. For example, he only had access to the company's 2010 financial statement, which, he said, showed more than double the income the tax return listed. He expressed "some doubts about the correctness of the tax returns as filed," concluding they were "prepared in a very taxable motivated fashion." He noted that the business website stated the company had "the world's largest inventory of semiconductor and manufacturing equipment parts."

The expert relied on the market approach, reviewing 31 comparable companies, and came up

with a value estimate of \$2 million. He concluded there was goodwill value attributable to the husband and applied a discount of 30 percent, resulting in a \$1.4 million intrinsic value. He acknowledged that, in light of the limited data available to him, his valuation did not meet AICPA standards. But, he said, his calculation was based on "sound foundation and fact and accounting theory." He maintained his work product for trial was "useful and ... a reasonable estimate of the value of the company as it [was]."

**Mixed message:** The trial court concluded it did not have sufficient evidence for a valuation. It cited the husband's statement that the company was worth zero dollars and found that "almost all of what [the expert] relied upon to form his opinion was not in fact correct." On review, the appeals court acknowledged the obstacles. "At best, husband's testimony regarding [the company] was vague, indefinite, and confusing," it said. The husband provided "scant and indefinable" information to the wife's expert. Also, the expert's valuation came with caveats. Then the appeals court changed its tune. Citing case law on what amounts to "sufficient and credible evidence," it said the trial court "had a

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relative wealth of information” with which to value the business. Both the husband’s and the wife’s experts stated figures. The wife’s expert used an accepted method, and, even though he did not produce an AICPA standard value, he called his determination “a reasonable estimate” of the company’s value as it was. Therefore, the appeals court ordered the trial court to perform a valuation and make an equitable distribution.

## Insights from Tax Court Cases Regarding Valuation Reports

In a recent conference presentation, a speaker observed that valuation report writing and report review is an overlooked subject that deserves more attention. While there is a great deal of material about report writing in business valuation standards, textbooks, and so on, some of the most important, and practical, lessons come from the courts.

1. *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148: This case is a great example of the need to “explain everything” when writing a business valuation report. The most common problem with reports is the failure to explain certain conclusions, especially discounts and multiples. “Don’t just state—explain.”

In a detailed, comprehensive opinion by Judge Halpern, the U.S. Tax Court in *Gallagher* addresses nearly every aspect of private company valuation, including the application of the guideline public company method and income approaches. It also has a particular focus on tax affecting, adjustments to financial statements and cash flow projections, calculation of the rate of return, application of subsequent events, and the determination of discounts for lack of control and lack of marketability.

“Judge Halpern had many problems with both experts not being able to explain things,” said the speaker. “The judge destroyed both sides.”

2. *Estate of Winkler v. Commissioner*, T.C. Memo 1989-231: An important concept about report writing is that another expert, after reviewing the report, should be able to replicate the valuation analyst’s work. It does not matter whether the conclusion of value is picture-perfect. If there are not enough details about how the expert came to his or her conclusion, the court may not accept it—as the *Winkler* case illustrates:

“Respondent’s expert appears to be extremely well qualified but he favored us with too little of his thought

processes in his report.... [H]is report briefly referred to the projected earnings approach, but the discussion was too abbreviated to be helpful. His testimony on the computer models he used ... suggested that a lot of work had been done but simply not spelled out in his report. That may also be the case in his price-to-earnings computations, but the Court cannot simply accept his conclusions without some guide as to how he reached [them].”

3. *Estate of Berg v. Commissioner*, T.C. Memo 1991-279: Citing cases in a valuation report is problematic for a few reasons. First of all, valuation experts are not attorneys, so to cite cases can be asking for trouble. Second, every valuation engagement is different, so a conclusion of value is predicated on the specific facts and circumstances of the subject. In the *Berg* case, the expert cited cases in backing up the amount of the discount he was claiming. The court was not pleased:

“We will not discuss these cases in any detail for two reasons. First, the facts of each case are distinguishable from those of the instant case. Second, the valuation of the appropriate discounts must take into account all relevant facts and circumstances of the particular corporation at issue.... This and other courts have decided many cases involving discounts. The fact that petitioner found several cases which approve discounts approximately equal to those claimed in the instant case is irrelevant. Therefore, in deciding the appropriate discounts in the instant case we will take into account all relevant facts and circumstances of petitioner’s interest in [the subject entity], and do not consider the amount of discount applied in other cases cited by petitioner as persuasive.”

4. *Louise B. Barnes v. Commissioner*, T.C. Memo 1998-413: This case emphasizes the importance of including all information that is available in the report. If the other expert finds more information, it will not be a good situation. In this case, the taxpayer’s expert used the market or guideline public company method to estimate the value of the stock, but the court noted:

“[H]e excluded three companies that [the IRS expert] used as comparables because he did not have their market trading prices as of the valuation date. In contrast, [the IRS expert] apparently easily obtained the stock prices by contacting the companies.”

The court also pointed out that the IRS’s expert visited

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the companies and interviewed the management. However, the taxpayer's expert did not do a site visit, nor did he "make any other factual investigation."

5. *Estate of Lewis A. Bailey v. Commissioner*, T.C. Memo. 2002-152: "Be consistent" is the lesson in this case, which considered the valuation of a corporation that owned and operated motels for estate tax purposes. The court picked up on some inconsistencies in the expert's report that led to the expert contradicting himself—something to avoid at all costs.

In one place in his report, the expert categorized the company as a mere holding company. In several other places, he said the company "owns and operates" motels and that the family manages the properties. This inconsistency came back to haunt him when he discussed the discount for lack of marketability (DLOM).

"From his report, we infer that [the expert] believes that management continuity would support an additional amount of marketability discount if [the subject company] were considered to be an operating company. As just noted, [the expert's] own report (although internally inconsistent in this regard), as well as the evidence in the record, fairly supports a conclusion that [the subject company] was in fact an operating company. Hence, [the expert's] own report supports a conclusion that his recommended marketability discount is understated insofar as it disregards continuity of management."

6. *Estate of True v. Commissioner*, 2004 U.S. App. LEXIS 24844 (Dec. 2, 2004), affirming T.C. Memo 2001-167: This is an estate and gift case in which the court was troubled by the lack of explanations on a number of issues. It went into details about the DLOM conclusion, the weighting of factors used in the guideline public company method and a minority discount.

For the DLOM for controlling interests, the taxpayer's expert relied on restricted stock and pre-IPO studies. The Tax Court takes issue with this:

"[W]e are troubled by the lack of any clear connection between [the expert's] report's general discussion of restricted stock and pre-IPO studies and the marketability discounts applied to the [subject interests]. For instance, there was no showing that the industries represented in the studies had risks and other attributes similar to the oil and gas industry. In fact, one of the pre-IPO studies specifically excluded natural resource companies from the companies being examined."

The court had more trouble with the report's guideline

company analysis:

"It provided no data to support the calculations of EBDIT, EBIT, pretax earnings, and book value for either the comparable companies or [the subject company]. Further, [the expert] did not explain the relative weight placed on each factor.... Without more data and explanations, we cannot rely on the final [expert's] report's valuation conclusions using the guideline company method."

The analysis of the minority discount also was a target:

"The final ... report vaguely described studies of acquisition transactions and REITs to support the chosen discount, but it did not cite specific studies, describe the studies' assumptions and findings, or analyze the control features of the ... subject interests. We therefore disregard [the final report's proposed minority discount]."

7. *Kohler v. Commissioner*, U.S. Tax Court, July 25, 2006: In a valuation report, an expert needs to follow the professional standards of the appraisal organization of which the expert is certified and prepare the report accordingly. If an expert is not certified, he or she should, at a minimum, meet the requirements of the *Uniform Standards of Professional Appraisal Practice*.

This was one of the issues in the *Kohler* case. While the valuation reports by *Kohler's* experts merited high praise from the court, it was the IRS's expert's report that felt the judge's wrath.

"[The IRS expert's] report ... was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP) ... and did not provide the customary USPAP certification."

**Final points** One interesting aspect of the *Richmond* case (*Estate of Richmond*, T.C. Memo. 2014-26) has to do with the valuation report submitted with the tax return. Attached to the return was not the final report, but a draft version—and it was marked up. And, of course, it wasn't signed. This is not the only case where this has happened and those who prepare and submit tax returns should know that the IRS and courts frown on this.

Although this article discusses Tax Court cases, the comments are relevant to all types of litigation. Make sure your expert is writing thorough, well-documented reports that are in compliance with the professional standards. Even if the conclusion is correct, the courts will disregard or minimize an expert's opinion if it is superficial.

# A 'Rose.com' Is a 'Rose.com': What's the Value of a Domain?

Many people are interested in what a glass of whisky costs, but what would you pay for "whisky.com"? The answer is \$3.1 million, the price paid earlier this year by the firm that owns "whisky.de," the German version. "Whisky.com" had been more or less "parked" for over a dozen years before it sold. How do you value domains? That's the question raised by a valuation analyst at a recent conference.

**Source of value.** There are two parts to every domain: a top-level domain (TLD) and a second-level domain (SLD). The TLD appears after the dot and is either generic (such as ".com," ".net," and ".edu") or country specific (such as ".de," ".uk," and ".eu"). It could also be a new custom TLD, which belongs to a single organization (e.g., an automobile manufacturer could be ".car"). The second part of the domain name, the SLD, appears before the dot, such as [trugmanvaluation.com](http://trugmanvaluation.com).

Domains have value because:

- They help users evaluate the reliability of search results;
- Like real estate, they establish "proximity" with users;
- Branded domains are part of a company's image; and
- Generic names can drive consumers to a brand and strengthen its market power (e.g., "toothpaste.com" is owned by Procter & Gamble, "motorcycles.com" is owned by Honda).

**Valuation approaches.** So how do you value these? The cost approach is not applicable here, so we look to the market and income approaches.

Under the market approach, the guideline public company method is rarely applicable. The guideline transactions method can be strong, although it is trickier to find comparables than analysts are accustomed to in business valuation. Comparables might be determined by:

- Site traffic;
- Number of letters (shorter is more valuable; last year, 92 percent of the biggest domain name sales were for names with fewer than 10 characters);
- Number of words—one versus two versus three

([drinkwhisky.com](http://drinkwhisky.com) is worth a lot less than whisky.com);

- Size of market (niche versus large consumer market);
- The TLD itself. The ".com" TLD is worth more than ".net" (over 83 percent of top sales last year were ".com" addresses); and
- Age of the URL and the site (older is typically more valuable).

Domain name sales data can be obtained from DN Journal ([dnjournal.com](http://dnjournal.com)), NameBio ([namebio.com](http://namebio.com)), or Sedo ([sedo.com](http://sedo.com)).

What about data from lawsuits, an otherwise common source? Not in this industry, according to the speaker. "ICANN, which manages domain registration, has a dispute resolution process for cyber-squatting and other issues, so few of these valuation issues get to the courts," he says.

As for the income approach, it can be based on projected cash flows, the relief from royalty method (what would it cost me to license this domain?), or discounted cash flow methods. These methods also require the identification of comparables.

Using the relief from royalty method is very similar to work done for purchase price or trademark valuations. By forecasting revenues and royalty payments, you can calculate the value of the domain by applying a discount rate to the avoided licensing costs. With this method, the analyst starts with royalty rates from [ktMINE](http://ktmine.com), [RoyaltySource](http://RoyaltySource.com), or [RoyaltyStat](http://RoyaltyStat.com). However, these can be "tough because it's rare to find only domain name licenses."

Other questions the analyst should be addressing:

- What is the correct discount rate? The WACC is a starting point, and there should be a good reason to veer from it.
- What is the expected life of a domain name? Generic words tend to last longer than brand-related terms.

Looking at discounted cash flow can be particularly helpful for unused websites that have been "parked." Those sites, generally lacking in content, might generate some ad revenue based on traffic and page views. Many acquired domains do, in fact, have revenue streams already associated with them. So "valuation is not always just a matter of assessing the name."

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