VALUATION Trends

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Reviewing Valuation Reports: Make Sure Third-Party Data Is Attributed and Analyzed

Every business valuation report involves the input and analysis of economic information from multiple sources, often from government or public resources, easily available on the Internet. Private subscription services also provide industry information, some of which is derived from public sources such as the Treasury Department or U.S. Census.

What's the problem with third-party material?

When reviewing an analyst's report—whether your own expert's or your opponent's--make sure that any third-party material has received proper attribution, with full citation, footnotes, and/or quotation marks, where appropriate. In most cases, a general reference to a document or source, such as "2000 Census" or "Bureau of Labor Statistics," requires more specificity.

Further, analysts must analyze the excerpted information and evaluate its relevance and impact on the subject company; if this analysis is lacking, the credibility of the report suffers. But when the analyst carefully correlates the industry and economic information available at the appraisal date to the subject company's financial circumstances, the inclusion of economic data conveys more meaning and persuasive power.

Industry analysis must be from the relevant time

Business appraisers often rely on industry profiles from private sources to complement the "Industry Analysis" sections of their reports. These, of course, should also be properly footnoted and attributed, and their correlation with the subject company woven into the analysis.

The problem: Many private providers update their industry profiles regularly, most often on a quarterly basis. If past profiles are not available, it may be difficult, if not impossible, to find one that reflects the chosen industry at the valuation date (or during a reasonable period thereafter). In these cases, the appraisal must state that: 1) conditions in the industry remained unchanged during the time following the valuation date; or 2) the industry profile data confirmed trends existing on the valuation date, which a reasonably well-informed buyer would be aware of.

In other words, the appraisal must comply with the central, methodological tenet of business valuation: that any economic data reasonably reflect conditions of the relevant market as of the valuation date.

Solutions are simple

When reviewing an expert appraisal, make sure all sources receive full and proper attribution. Any direct quotations from third-party sources must, of course, be cited. But so should ideas the analyst has gleaned from other sources, facts that aren't widely known, and opinions or judgments by other people.

What doesn't require attribution: the analyst's own ideas, observations, and conclusions, as well as facts that are widely known and information that's generally considered "common knowledge." It may sound obvious, but reviewing an appraisal to ensure that third-party materials have received sufficient attribution and analysis will allow you to strengthen your case—or uncover a weakness in your opponent's.

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Top Ten Ways to Succeed in A Judicial Appraisal Action

Judicial appraisal actions often involve sophisticated financial applications, analysis, and assumptions. To present appraisal evidence with the greatest likelihood of success, attorneys and their business appraisal experts will want to heed these "top ten" suggestions:

#10. *Be familiar with precedent and the judge's prior decisions.* Which valuation methods have met with the particular court's prior approval? A new or less-favored method requires a well-prepared explanation by the experts and persuasive reasoning by the attorneys.

#9. *Present an effective witness.* You'll want the business appraiser to tell a clear story about how the company makes money and how that ties into its valuation. The analyst needs to describe the approaches and methods, explain the inputs and assumptions, and determine an appropriate weight for each method. If a particular method is not appropriate, the expert should be prepared to explain, as mistakes and last-minute changes will surely undermine credibility.

#8. *Present an effective report*. The valuation report should be in plain, understandable terms, with ample use, where appropriate, of charts, graphs, and CDs with spreadsheets. Take advantage of available resources and technology—but don't bury the court with paper.

#7. *Decide whether to prepare a rebuttal report.* This is a tactical decision, for which sensitivity analysis is critical. If the court is not completely persuaded by your expert's report, then submission of a rebuttal or alternate valuation report gives the court a basis on which to rule (other than adoption of your opponent's expert report.)

#6. *Use reliable management projections.* By and large, courts prefer contemporaneous management projections, prepared in the ordinary course. Projections prepared when a fairness opinion, acquisition, or other major deal is in the offing are generally considered less reliable.

#5. *Be prepared to justify a DCF.* All inputs and aspects of a discounted cash flow analysis (DCF) will come under the court's scrutiny, including the discount rate and its inputs and the terminal value. Attorneys and their experts should make sure the analysis will "hold together" under cross-examination.

#4. *Check your 'reality-checks.'* In many appraisal actions, courts have found reality or "sanity" checks helpful, such as market prices, control premiums, evidence of a "thorough and fair auction," etc.

#3. *Don't forget interest.* If the parties bear the burden of proof in determining interest in a statutory appraisal action, make sure your experts assist with this calculation. Absent reliable evidence, courts will fall back on the statutory rate.

#2. *Expert should be skeptical.* The appraiser should also be sure to test any management assumptions and projections against a reasonableness or "reality" check.

#1. *Expert must be independent.* Business appraisers are important members of the "litigation team," but they must retain their independence. Experts who appear "too cozy" with their own side risk losing their credibility in the court.

Allocation of Stock Purchase Price to Non-Compete Must Be Clear, Unambiguous

***Becker v. Comm'r of Internal Revenue,* 2006 Tax Ct. Memo LEXIS 268 (December 13, 2006)**

The Tax Court reviewed the two primary rules governing the allocation of a portion of a stock purchase price to a covenant not to compete and found that the overriding standard—as in most contract construction cases—is the clarity of the provisions and, failing that, evidence of the parties' intent.

Family company buys out shareholder/son

Internecine disputes led the Becker Holding Corporation, a family owned, Florida citrus operation, to purchase all shares held by one Becker son for $23.9 million, payable with $5 million in cash and the remainder by an installment note. None of the purchase documents provided for an allocation of the price to a covenant not to compete, which the Becker son executed at the sale.

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But in filing its tax return, the company allocated the $5 million to the non-compete, declaring an amortization deduction. The IRS asserted a deficiency, consolidating the action with one against the son, who'd claimed capital gains tax on the total consideration paid to him (and not ordinary income, as would have resulted from the company's characterization).

The relevant rules

In deciding the case, the Tax Court applied the standards of the 5th and 11th Circuits:

1. *'Strong proof rule' and 'mutual intent test'.* When considering tax allocation cases involving a covenant not to compete, the 5th Circuit adopted the "strong proof rule," which held that when the parties have set out the covenants with an assigned value, then only "strong proof" can overcome the declarations.

   Over time, the 5th Circuit departed from the rule, adopting the more specific "mutual intent test," where the question becomes: "Did the parties… when they signed the agreement, intend to allocate a portion of the purchase price to the covenant not to compete?"

2. Danielson *rule*. In cases where the parties do allocate a stated portion of the purchase price to the non-compete, then the rule of the *Danielson* case (3rd Circuit, 1967), adopted by the 5th and 11th Circuits, applies:

   > A taxpayer who enters into a transaction…to sell his shares and executes a covenant not to compete for a consideration specifically allocated to the covenant may not, absent a showing of fraud, undue influence and the like…challenge the allocation for tax purposes.

The *Danielson* rule holds true even if, as in that case, "the explicit allocation had no independent basis in fact or arguable relationship with business reality."

Both rules consistent with this case

Both the Becker son and the IRS contended that the *Danielson* rule applied, as the purchase documents clearly allocated the entire consideration to the stock. Therefore, the transaction should result in capital gains to the taxpayer, with nothing allocable to the non-compete, as the company argued.

The company claimed the "mutual intent" test controlled, because the parties intended to allocate some value to the non-compete, and thus the Court should independently determine its value. (Note: Neither party obtained an appraisal at the time of the stock purchase agreement.)

The Tax Court held that the outcome was the same under both standards. The purchase documents clearly allocated the entire price to the shareholder's stock (*Danielson* rule). Although the parties obviously considered the non-compete an important element of the deal, nothing in their transaction—including their discussions and negotiations—evidenced a mutual intent to allocate a portion of the price to that provision (mutual intent test).

Notably, the company had argued the parties' failure to obtain a formal valuation of the shareholder's stock had evinced ambiguity about allocating a value to the non-compete. But the Court firmly disagreed, stating that the "absence of a third-party appraiser does not render the purchase documents ambiguous," especially when the parties themselves clearly valued the stock at $23.9 million.

Another FLP Deduction Disallowed for Lack of Viable Business Purpose

Estate of Korby v. Comm'r of Internal Revenue, **2006 U.S. App. LEXIS 30087 (December 8, 2006)**

After retiring with a modest estate, the Korbys attended a free estate-planning seminar given by an attorney, who later helped them transfer nearly $2 million in assets to a living trust. The trust then retained a 2% general partnership interest in a family limited partnership (FLP), while the Korbys eventually gifted the 98% limited partnership (LP) interest to their sons.

When the elder Korbys died, both their estates listed the general partnership interests on their respective estate tax returns but excluded the gifted LP interests. The IRS assessed deficiencies against both estates totaling over $2.1 million, claiming the Korbys had

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retained the "possession and enjoyment of" the full value of the FLP assets.

Three strikes against the FLP

At trial, the Tax Court upheld the deficiencies, citing three issues against the Korbys. First, the Court found that they had "an implied agreement" to retain all rights to the FLP's assets, to use as income for as long as they needed it, upon request and without scheduled disbursements. Over time, the FLP had made distributions to the living trust ostensibly as "management fees" (which had gone toward the Korbys' living and medical expenses). But there was no written management agreement, nor were there any regularly scheduled disbursements; the husband had not tracked his "management" fees for the FLP assets or reported any fees on his personal income tax returns.

Second, the Korbys "essentially stood on all sides of the partnership," having formed the FLP for tax avoidance rather than credit protection or any other independent business purpose.

Finally, as Mrs. Korby had predeceased her husband, her estate claimed a marital deduction, arguing that all her rights to the FLP assets had passed to her husband under the terms of the living trust. In answer to this claim, the IRS had pointed out that pursuant to the gift transfer to the sons, the husband had never received any rights to the FLP income or assets. In the estate/gift action, the Korbys' trustees contended this statement by the IRS constituted a "judicial admission" that the elder Korbys had lacked control over the FLP assets.

But the Tax Court rejected the argument, and the Court of Appeals confirmed (as it did all major aspects of the opinion), noting the IRS had always claimed that both Korbys had retained an interest in the FLP assets. "Such a claim is not inconsistent with contending the interest did not pass from [wife to husband] at the time of her death via the terms of the living trust."

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