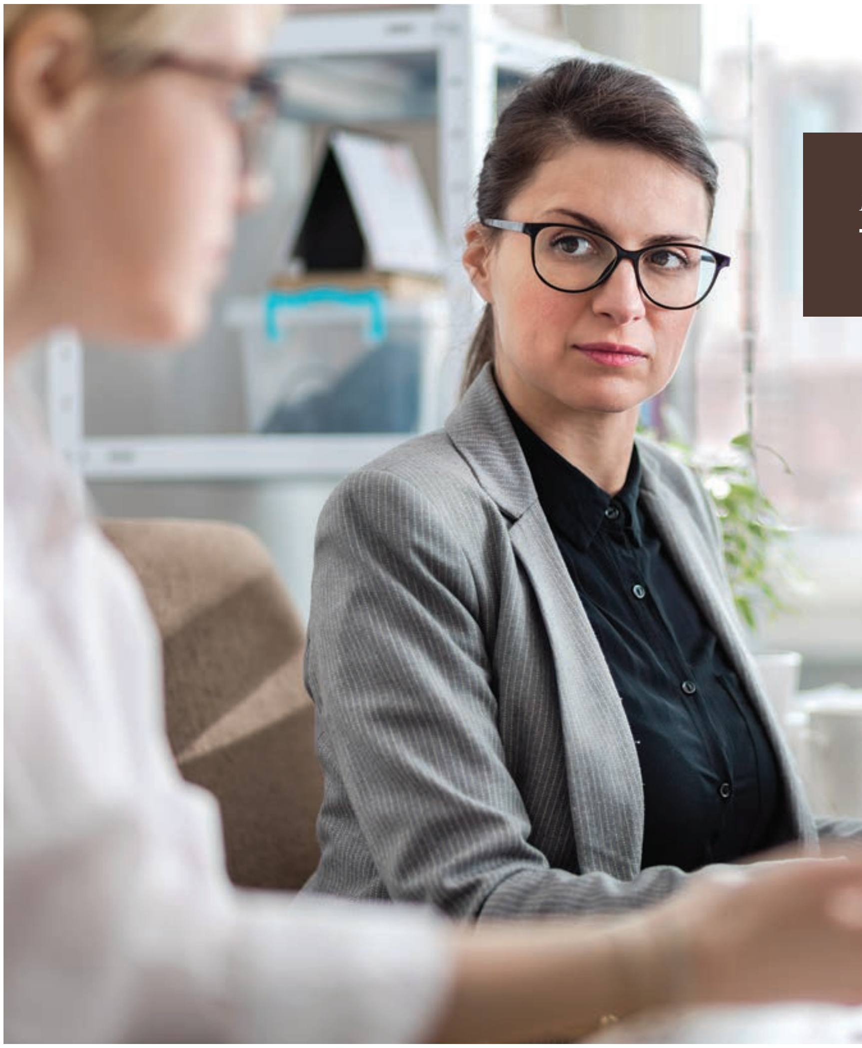
Valuation & Litigation Briefing



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R.D. Clark & Sons

Tax-affecting debate continues

For decades, business valuation experts and the IRS have been at odds regarding the practice of "tax affecting" the earnings of pass-through entities. Though the U.S. Tax Court has consistently rejected this practice, the court has recently softened its stance and other courts have been less rigid on the matter. A recent Connecticut appellate court decision highlights both sides of the debate — and the importance of considering the facts of the specific case.

Ongoing debate

Generally, so-called "pass-through" entities pay no entity-level federal taxes on their income. Instead, a pass-through entity's income and deductions flow through to the interest holders, who are responsible for the entity's federal income tax liability. Examples of pass-through entities include partnerships, limited liability companies (LLCs), S corporations and sole proprietorships.

Some business valuation experts argue that every business pays some form of federal taxes, and hypothetical investors factor taxes into their investment decisions. Plus, not every hypothetical buyer would be eligible to elect pass-through status. When tax affecting, valuation experts apply corporate tax rates to the earnings of pass-through entities to level the playing field and account for the impact of taxes on business value.

A pass-through entity's income and deductions flow through to the interest holders, who are responsible for the entity's federal income tax liability.

The IRS, however, contends that tax affecting ignores the tax benefits of operating as a pass-through entity and, therefore, underestimates the value of a business interest. For more than 20 years, this position has generally prevailed in the U.S. Tax Court — but now the tides appear to be shifting. (See "Has the Tax Court opened the door to tax affecting?" on page 3.)

In other courts, tax affecting has received a mixed reception. Courts are generally reluctant to offer bright-line rules on the applicability of tax affecting, instead tailoring their rulings to the case facts.

Buyout gone bad

The Appellate Court of Connecticut's decision in *R.D. Clark & Sons* is a recent example of a case where tax affecting was rejected when valuing an S corporation. In *Clark*, three siblings owned one-third interests in a family business. The owners acted as the company's officers and directors, until one was terminated. He subsequently resigned as an officer and director.

Has the Tax Court opened the door to tax affecting?

Dating back to its 1999 decision in *Gross v. Commissioner*, the U.S. Tax Court has consistently rejected tax affecting when valuing pass-through entities. However, in 2019, the court in *Estate of Jones* seemed open to the practice.

In *Estate of Jones*, the court accepted the estate expert's use of tax affecting when valuing two related pass-through entities — an S corporation and an LLC — that made up a family-owned timber enterprise. The expert discounted earnings using a 38% assumed rate for combined federal and state taxes. Significantly, in reaching his value conclusion, the expert also added a premium to reflect the benefits associated with avoiding double taxation.

The court distinguished its previous tax-affecting rulings as involving different facts. It found that by considering both tax costs and benefits, the estate's expert had "more accurately taken into account the tax consequences of [the company's pass-through] status" than the IRS's expert had.

Two years later, the company sued the departing owner and his new company, alleging unlawful use of proprietary information to compete with the family business. The departing owner countersued on grounds of shareholder oppression and sought to have the family business dissolved.

Pursuant to Connecticut law, the company elected to buy back the departing owner's shares. When the parties couldn't agree on the fair value of those shares, the court was asked to intervene.

Trial court valuation

Both sides hired business valuation experts who applied the income approach and tax affected the pass-through entity's earnings. The company's expert applied a 25% entity-level income tax rate, and the departing owner's expert applied a 12.6% rate. The trial court generally agreed with the approach used by the company's expert, but the court conducted its own valuation — without any tax-affecting adjustment.

On appeal, the company argued that not tax affecting its earnings "results in an artificially inflated value of the corporation because it fails to take into account that shareholders will not receive the full benefit of the corporation's earnings because they must pay income tax on same." The appellate court observed that Connecticut law doesn't address the issue and that the propriety of tax affecting "remains the subject of considerable debate."

Ultimately, the appellate court concluded that the trial court hadn't abused its discretion by rejecting tax affecting because there was "considerable support for its approach," including various Tax Court decisions. In addition, the appellate court found that "the present case was ill-suited to tax affecting earnings in light of [the company's] practice of extending loans to shareholders to cover their tax liabilities and then retiring those loans through the payment of bonuses, and it was entirely foreseeable that such a practice would continue."

Facts matter

The court in *Clark* discerned no bright-line rule on tax affecting. But one point seems crystal clear in this decision: Valuation experts must consider the appropriateness of tax affecting within the context of the case and be prepared to explain the reasoning underlying their tax-affecting approaches. ■

How will financial reporting changes affect the valuation process?

When valuing a private business, financial statements are an important source of information. But recent changes to the accounting rules complicate matters. Here are some major financial reporting changes that are underway — and how they might impact the valuation process.

Coming soon

In recent years, the Financial Accounting Standards Board (FASB) has issued the following three major accounting updates:

1. Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers.* The update requires revenue from long-term contracts to be reported using new principles-based guidance. The changes affect the timing, but not the amount, of revenue reported over the life of a contract. The updated guidance also calls for expanded disclosures regarding the nature, amount, timing and uncertainty of revenue that's recognized.

> *Varying effective dates could result in major differences between the financial statements of public vs. private companies.*

The updated standard has significantly affected certain types of businesses, including construction, software, wireless and media companies. It went into effect in 2018 for calendar-year public companies and 2019 for private companies and nonprofits. However, the FASB recently gave franchisors that aren't public business entities the option to postpone implementation until calendar-year 2020 to give them extra breathing room during the novel coronavirus (COVID-19) crisis.

2. ASU No. 2016-02, *Leases.* The updated standard on long-term leases goes into effect in 2019 for calendar-year public companies and in 2022 for private businesses and nonprofits. It puts leases on the balance sheet, requiring companies to report right-to-use assets and corresponding liabilities for lease obligations. It also calls for expanded footnote disclosures about leasing transactions. These changes will make lessees appear more leveraged than under the prior rules.

3. ASU No. 2016-13, *Financial Instruments — Credit Losses.* Banks and other companies that lend money to third parties will soon be required to immediately record the full amount of expected credit losses in their loan portfolios. The updated standard transitions from the use of an "incurred loss" model under current practice to a "current expected credit loss" (CECL) model. The change, made in response to the 2008 financial crisis, is designed to provide stakeholders with more timely, relevant information.

Last year, the FASB set the effective date for the credit loss standard as 2020 for calendar-year public companies and 2021 for private ones. However, a provision of the Coronavirus Aid, Relief, and Economic

Security (CARES) Act has delayed implementation of this standard to the earlier of 1) the end of the COVID-19 crisis, or 2) December 31, 2020.

Processing the changes

The FASB has also changed its general philosophy for setting effective dates. Going forward, the effective dates of major updates for small reporting companies (SRCs), private companies, nonprofits and employee benefit plans will be at least *two* years after the effective dates for large public companies. Varying effective dates could result in major differences between the financial statements of public vs. private companies when they're implementing major financial reporting changes.

Financial statements may be used as the basis for projecting future income, estimating discount and capitalization rates, and adjusting the preliminary value estimate for interest-bearing debt. It's important for valuation experts to understand the accounting rules that the subject company is using — and make adjustments if its accounting methods differ from industry norms or guideline companies used in the market and income approaches. To the extent that the balance sheet has been affected by accounting rule changes, adjustments may also be needed when using the cost approach.

Muddying the waters

When valuing a private business, experts need to understand the specific accounting rules that the subject company and any guideline companies follow. In some cases, adjustments may be needed to avoid apples-to-oranges comparisons. Contact your valuation professional for more information. ■

Financial statement adjustments are essential in business valuation

The value of a business under the income and market approaches depends on how much earnings it will generate in the future. Historical results are a helpful starting point, but they usually need to be adjusted to reflect objective, unbiased data — and when projecting future performance.

Nonrecurring items

The first category of adjustments accounts for any unusual or nonrecurring items, such as revenue from a one-time custom project or legal expenses associated with a pending lawsuit. These items aren't expected to continue in the future and thus have no value to a potential buyer. As a result, they need to be eliminated from the company's earnings.

The novel coronavirus (COVID-19) pandemic is an example of an unprecedented event that has had a major impact on business earnings. Going forward, valuation experts will use financial statements from fiscal year 2020 to estimate business value. And they'll need to consider how the pandemic affected earnings, cash flow and asset values. Fiscal year 2020 financial statements will need to be adjusted for effects of COVID-19 — both positive and negative — that aren't expected to happen again. These could be temporary changes in demand, one-time insurance gains, bad debt write-offs and supply chain disruptions.

However, projections of future earnings also must reflect effects of the pandemic that are expected to continue over the long run. For example, some workers may continue to work from home after shelter-in-place mandates expire. Some businesses may decide to increase their insurance coverage and safety stock levels to hedge against future business disruptions. Business models, supply chains and cost structures may be permanently altered by this epic event. So, when making financial projections, valuators must go beyond multiplying historical results by a long-term growth factor. They'll also need to address measures the business has taken to mitigate this risk factor going forward.

Discretionary spending and accounting norms

Fair market value is typically based on the future cash flow that a *hypothetical* prospective buyer could generate from the business's operations. Certain adjustments are designed to bring a company's expenses in line with industry norms. Discretionary costs that commonly require adjustment include owners' compensation and related-party transactions. These adjustments are especially important when valuing a controlling interest in a business.

Valuators also evaluate the company's accounting methods. Adjustments may be needed to align the business's financial reporting practices with comparable companies that are used to benchmark performance, gauge risk and return, and calculate pricing multiples.

Examples of accounting method differences include reporting for inventory, pension reserves, depreciation, income taxes and cost capitalization vs. expensing policies. Small businesses also may use cash- or tax-basis reporting, rather than conforming to U.S. Generally Accepted Accounting Principles (GAAP). (Also see "How will financial reporting changes affect the valuation process?" on page 4.)

Last-minute changes

After a valuator makes a preliminary estimate of a company's value, he or she considers additional fine-tuning. Common last-minute adjustments include:

- Changes to working capital (compared with the company's normal operating needs),
- Contingent or unrecorded assets and liabilities, and
- Nonoperating assets.

In some situations, it also may be appropriate to take discounts for lack of control and marketability associated with a business interest.

No universal formula

Adjustments vary depending on the nature of the business and the terms of the engagement. Discuss these issues with your valuation expert. He or she can determine what's appropriate for your situation. ■

Factoring governing documents into the valuation equation

When valuing a business interest — as opposed to valuing the *entire* entity — it's critical for your expert to examine organizational documents. This examination helps determine the interest's relative levels of control and marketability, as well as the cash flows the interest is entitled to receive.

A discount for lack of control may be appropriate when an interest holder doesn't control management, operations, distribution of earnings and major business decisions. Conversely, a discount for lack of marketability may be appropriate to reflect the time and cost required to convert the interest to cash.

Sometimes, a discount for lack of control may be appropriate for certain majority interests. For example, if governing documents require a two-thirds "super majority" to liquidate the business, then a 60% voting interest would likely receive a discount to reflect its inability to control those decisions.

Issues to examine

When assessing these issues, relevant governing documents may include:

- Articles of incorporation and corporate bylaws,
- Partnership agreements,
- Limited liability company (LLC) operating agreements, and
- Buy-sell, voting trust and other shareholder agreements.

Other areas to examine are:

Type of interest. Companies may issue different types of ownership interests with different rights. For example, a company may have voting and nonvoting interests, preferred shares, profits interests, and promote or carried interests. Governing documents explain how these interests measure up.

To illustrate, compared to common shareholders, preferred shareholders typically enjoy advantages, such as higher and more regular dividends and a preference on liquidation. But the impact of these advantages on value depends on the precise terms of governing documents. For example, because preferred shares have limited upside potential, those that are convertible into common shares are generally more valuable.

Transfer restrictions. Discounts for lack of marketability often apply to interests in closely held businesses. These discounts may be attributable to the lack of a public market, as well as to transfer restrictions imposed by the company's governing documents.

Companies may issue different types of ownership interests with different rights.

Examples include prohibitions against transfers outside the family or to another ownership group, rights of first refusal, and restrictions on transfer without approval from other owners. A buy-sell agreement may affect an interest's value by restricting certain transfers and setting the price for transactions, preventing an owner from realizing the interest's fair market value.

Watch the wording

When valuing a business interest, the wording of its organizational documents is critical. The only way to determine the appropriate discounts for lack of control and marketability — or premiums for certain advantages — is to understand the interest's relative rights, restrictions and preferences. ■

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