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How to reevaluate risk in the new normal

As we emerge from the COVID-19 pandemic, many business owners and managers are grappling with the prospect of a "new normal." Although the post-pandemic business climate will take time to fully understand, companies are already encountering a variety of new or altered risk factors. Financial experts are well-suited to help business owners get a better handle on risk when evaluating operating and capital budgeting decisions.

Measuring risk in today's landscape

The pandemic has altered the risk landscape for most businesses. In some cases, the pandemic created *new* risks by permanently changing the way we live and do business. For example, greater reliance on a remote workforce has lowered fixed business expenses and ushered in opportunities for companies to offer more flexible work schedules. But remote working arrangements also bring new cybersecurity and HR challenges.

> ***A hurdle rate is the minimum return required to compensate an investor based on the level of risk involved.***

In other cases, the pandemic may have increased *existing* risks. For instance, the pandemic highlighted cybersecurity and concentration risks with vendors, as well as risks associated with a global supply chain. Other companies may face *less* risk than before the pandemic. For example, competitive risks may have lessened if major competitors went out of business or relocated during the pandemic.

Factoring risk into operating decisions

In today's unprecedented market conditions, outside financial experts can help business owners identify and evaluate risks and incorporate them into their decision-making. Financial experts are experienced in assessing a variety of risks when valuing a business or calculating lost profits damages using the income approach.

For instance, when using discounted cash flow (DCF) analyses, a financial expert considers industry, market and company-specific risks to determine the discount rate. This rate is then used to calculate the present value of projected cash flows. Higher discount rates generally equate with higher levels of risk and lower values.

Similarly, DCF models can help business owners make *operating* decisions that reduce the company's risk and enhance its value. For example, management may take action to reduce company-specific risk factors, such as a lack of management depth, an inferior business location, a concentrated customer base or increased competition. Over the long run, reducing risk factors can add value to the business.

Analyzing investment alternatives

DCF models also can help business owners make *capital budgeting* decisions. Typically, decisions about whether to pursue a project — such as building a new factory, hiring a new salesperson or launching a new product line — are based on whether expected returns will clear a "hurdle" rate. When considering multiple capital budgeting alternatives, management prioritizes projects by the extent to which their expected returns exceed management's hurdle rate.

A hurdle rate is the minimum return required to compensate an investor based on the level of risk involved. Often, companies use their weighted average cost of capital (WACC) to establish the hurdle rate. In simple terms, WACC is the risk-adjusted average rate of return of a business's lenders and investors.

Financial experts also commonly use WACC to determine the discount rate used to value a business or discount lost profits to present value. Determining an appropriate discount rate when calculating lost profits damages requires an expert to consider risks associated with the product or business line that was damaged, which may be higher or lower than the company's overall risk level.

Similarly, a capital investment may have a different risk profile than the business's other activities. For instance, entry into new product lines or foreign markets may involve greater risk and, therefore, require the business to clear a higher hurdle rate.

Looking forward

In the new normal, historic hurdle rates may no longer be relevant. Financial experts can help businesses navigate in this new environment and make informed decisions based on their current risk profiles. ■

Estate planning for business owners

Act soon to take advantage of favorable federal tax rules

Year end is always a good time for business owners to reevaluate their estate plans. But the exercise may be particularly important this year because Congress is considering proposals that could make the federal estate and gift tax rules less taxpayer friendly. Here are the pertinent details.

Timing counts

Under current tax law, the federal gift and estate tax exemption per individual is $10 million, with annual indexing for inflation. For 2021, the inflation-indexed exemption is $11.7 million, or effectively $23.4 million for a married couple. (Beware: Some states impose estate or inheritance tax at a lower threshold than the federal government does.)

Unfortunately, the generous federal gift and estate exemptions are set to expire on December 31, 2025. The exemptions also could be reduced sooner if Congress passes legislation to generate revenue to fund infrastructure expenditures, economic stimulus or other spending.

Earlier this year, President Biden proposed major changes to the treatment of property that's gifted or is transferred at death. It's generally believed that any new rules that Congress would adopt would apply *prospectively*, so there still may be time before year end to make proactive tax moves to take advantage of current rules.

Estate of Jackson: How much was the King of Pop worth?

Pop singer Michael Jackson died in 2009. The U.S. Tax Court recently resolved a dispute between Jackson's estate and the IRS over the fair market value of Jackson's image and likeness, as well as his interests in two trusts that held interests in certain music catalogs.

An accounting firm had originally valued Jackson's image and likeness at only $2,105 on the estate's original federal estate tax return. For trial, the estate hired four valuation experts who determined that, at the time of Jackson's death, his image and likeness were worth $3 million and his entire estate was worth $5.3 million. The IRS relied on only one expert, who valued Jackson's image and likeness at $161 million and his entire estate at $481 million.

A significant aspect of the case was the *credibility* of the valuation experts who testified at trial. The IRS's expert damaged his credibility by perjuring himself several times at trial. Among other things, he lied when he testified that he'd never been retained by the IRS before.

The court sided primarily with the estate, finding that Jackson's image and likeness had been severely tarnished by child sexual abuse allegations in the years preceding his death. It valued these assets at $4.1 million using the income approach.

However, the court sided primarily with the IRS regarding the value of unreleased songs in one of the music catalogs, valuing the estate's interest at $107 million under the income approach — almost $105 million more than what the estate had claimed. Despite this sizable discrepancy between the court ruling and the original estate tax return, the court imposed no valuation penalties because the estate's valuations of the assets "were not unreasonable."

Lower exemptions, higher rates

One proposed change would lower the federal gift and estate exemptions to $3.5 million for estate tax and only $1 million for gift tax. Other proposed changes would replace the current 40% estate and gift tax rate with graduated rates as high as 65% for estates and gifts over $1 billion.

The effects of these changes are significant. Currently, an individual who dies with a $10 million estate would face no estate tax liability. If this proposal becomes law, the estate tax would be more than $2.9 million.

No more stepped-up basis

Under current law, when people inherit appreciated assets, they receive a so-called "stepped-up" basis. In other words, an heir's basis in an asset is equal to its fair market value at the time of the deceased's death.

President Biden has proposed eliminating the stepped-up basis and treating the receipt of assets because of death as a "realization event." Under this proposal, the deceased owner of an appreciated asset would realize a capital gain at the time of the transfer. The amount of the capital gain would be the excess of the asset's fair market value on the date of death over the deceased's basis in that asset.

Certain exclusions would apply. For example, payment of tax on the appreciation of certain family-owned and operated businesses wouldn't

be due until the business interest is sold or the business ceases to be family-owned and operated.

Possible restrictions on discounts

Under current law, business owners can minimize gift and estate taxes by transferring *minority* interests to their children or other heirs. These interests are generally entitled to substantial discounts for lack of control and marketability.

Biden's proposed changes would eliminate most valuation discounts for transfers in which both the transferor and transferee are part of the family that controls the business. So, time may be of the essence when gifting family business interests.

Start with a valuation

As of this writing, it's uncertain which, if any, of these proposals will be passed by Congress. But, one way or another, today's taxpayer friendly estate and gift tax rules won't last indefinitely. A business valuation professional can help determine tax-smart estate planning and gifting strategies for private business owners in light of evolving federal (and state) tax rules. ■

FAQs about fairness opinions

Mergers and acquisitions activity surged in the United States in the first half of 2021. The surge is driven by a boom in the stock market; historically low borrowing costs; and excess capital built up by companies, private equity funds and special purpose acquisition companies (SPACs) during the COVID-19 pandemic.

However, uncertainty about taxes, regulations, inflation and geopolitical risks abounds in today's marketplace. A fairness opinion can protect against costly litigation if a deal's projected results unexpectedly fall short or insolvency becomes likely. Here are answers to potential questions clients may have about these expert opinions.

What is a fairness opinion?

Simply put, a fairness opinion addresses whether a transaction appears "fair" from a *financial* point of view. Fairness opinions help confirm that dealmakers fulfilled their fiduciary duty to act in the best interests of the company and its shareholders. However, fairness opinions don't address legal or structural fairness, nor do they constitute an endorsement or a guarantee of a particular transaction.

When preparing a fairness opinion, a financial expert usually estimates a range of values regarding a proposed transaction. Theoretically, the ceiling of this range represents the highest price a prudent buyer would be willing to pay; the floor is the lowest price a prudent seller would accept. The analysis typically presumes that neither party has been forced to buy or sell, and that both parties have reasonable access to relevant financial data.

Another proxy for the lower end of a fairness range is the amount that dissenting shareholders could reasonably expect to obtain in a statutory appraisal action. Legal counsel can help the fairness opinion provider define the appropriate standard of value.

How do market conditions factor into the opinion?

A fairness opinion is valid only on a particular date. A transaction may be fair one day but unfair the next because of changing market conditions or product obsolescence, for example.

> *A fairness opinion addresses whether a transaction appears "fair" from a financial point of view.*

Generally, fairness opinions are performed as close to the transaction or proxy date as possible. Opinions dated too early or not updated for changing conditions may not withstand scrutiny — especially in volatile markets.

When are fairness opinions appropriate?

Most people associate fairness opinions with *public* companies undergoing high-profile management buyouts, hostile takeovers or going-private transactions. But fairness opinions have become increasingly popular among *private* businesses with complex deal structures, related-party transactions and vocal shareholders that don't own a controlling interest in the company.

Fairness opinions aren't legally mandated, but they can help facilitate major transactions, such as mergers, spin-offs, stock repurchases and divestitures. Businesses that reorganize out of court or under Chapter 11 of the U.S. Bankruptcy Code may choose to obtain fairness opinions on behalf of creditors and other stakeholders.

In addition, buyers and sellers use fairness opinions to support their strategic decisions and to defend against lawsuits. And some loan covenants require fairness opinions to protect the bank's financial interests against fraudulent conveyances.

Who can help?

Courts generally perceive fairness opinions as lacking objectivity if they're prepared by company insiders, business brokers and other people who helped negotiate the deal. Instead, independent third parties — such as a credentialed business valuation professional — are usually hired to avoid potential conflicts of interest and withstand scrutiny if shareholders later challenge a deal. ■

Court favors "exceptionally knowledgeable" valuation expert

In a recent breach of fiduciary duty case, *Marion Coster v. UIP Companies, Inc.*, et al., the Delaware Court of Chancery dismissed the plaintiff's challenges to a stock sale involving her late husband's business. The defendants made a proactive move that led to this favorable outcome — hiring a qualified, experienced expert to value the business before the sale.

Tensions mount

The case involved a real estate investment services company that had been owned equally by the plaintiff's late husband and his cofounder. After the plaintiff inherited her husband's 50% interest, she had a series of disagreements with the cofounder regarding a buyout of her interest and

the election of directors. So, she filed a lawsuit to obtain a court-appointed custodian.

Subsequently, the cofounder obtained an independent valuation of the company. Then the company sold unissued shares representing one-third of its equity to an executive (and board member) for approximately $41,000.

The plaintiff filed a second lawsuit seeking to invalidate the stock sale. A majority of the board was "interested or lacked independence from a party who was interested in the transaction." So, the court invoked the "entire fairness" standard of review, under which the defendants had the burden of proving that the transaction was fair in terms of both process and price.

Court finds no bias

The plaintiff alleged various process defects that, she argued, compelled a finding of unfairness. A key allegation was that the expert who valued the shares was biased. The plaintiff claimed that the valuator had commented, before conducting his analysis, that "there is no value" to the business.

The court found the valuator to be credible and unbiased because he held a senior position at his firm and had obtained many professional licenses.

However, the court found the valuator to be credible and unbiased because he held a senior position at his firm and had obtained many professional licenses. He also had extensive experience valuing real estate entities, making him "exceptionally knowledgeable about the industry."

In addition, the plaintiff hired a rebuttal expert who attacked several aspects of the business valuation. The court acknowledged that some of the rebuttal expert's criticisms had a "basis in theory" and that many of the valuator's conclusions were based on professional judgment.

However, the court found that the valuator's income approach provided the most reliable indicator of value — particularly in light of the plaintiff's failure to offer an alternate indicator. Accordingly, the court ruled that the stock sale satisfied the entire fairness standard and dismissed the plaintiff's claims.

Lesson learned

Transactions involving a company's stock sometimes attract lawsuits from shareholders who don't have control over business decisions. By seeking independent valuation expertise, executives and controlling shareholders can demonstrate that they acted in good faith and conducted thorough due diligence. ■

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