Valuation & Litigation Briefing

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Limited time opportunity

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Absent expert testimony, court values interest in professional practice

Wouch Maloney
CPAs & BUSINESS ADVISORS

415 Sargon Way • Suite J • Horsham, PA 19044
Tel: (215) 675-8364 • Fax: (215) 675-3879
www.wm-cpa.com

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How valuators can help distressed companies

The COVID-19 pandemic took an economic toll on businesses globally. Although the U.S. public health emergency ended on May 11, 2023, many companies are continuing to feel the pandemic's effects. Factors driving some to the brink of bankruptcy include lackluster demand, scaled-back corporate budgets, supply-chain issues, and rising labor and commodity prices.

Business valuation professionals can provide guidance for struggling companies. These experts are well-versed in risk assessment and can work with management to estimate going concern value in light of turnaround plans and, if necessary, estimate liquidation value.

Spotting red flags

Assessing risk is a critical component of the valuation process. Valuators are trained to recognize the warning signs of financial trouble and can advise management on strategies for reducing risk. Red flags that are readily apparent include:

- Declining profits or revenue,
- Increases in bad-debt write-offs or outstanding receivables without a corresponding increase in revenue,
- Increases in obsolete or slow-moving inventory,
- Mounting payables,
- Mass layoffs and voluntary departures of key employees,
- Loss of key customers,
- Late or missing financial records, and
- Fully extended lines of credit.

Other warning signs are more subtle. For example, distressed companies might shore up cash flow by deferring maintenance and repairs, cutting R&D or marketing budgets, depleting inventory, and selling fixed assets. Or they may heavily discount prices to retain customers. These tactics can produce short-term benefits, but they may do permanent damage that can be difficult for the company to recover from over the long term.

Overcoming valuation hurdles

Valuing distressed companies involves challenges that aren't usually present in valuations of healthy companies. For one thing, it can be difficult to identify comparable stocks and transactions, so the market approach may be less reliable.

So, experts tend to focus more on the income approach when valuing troubled companies. However, discounted cash flow techniques may involve special challenges. For instance, the past five years of financial results may not be a reliable

How do high interest rates and low stock prices affect value?

When valuing a business, it's important to consider both internal and external factors. Internal factors include a subject company's fundamentals, such as the nature of the business, financial performance, growth potential and management quality. Two significant external factors are:

1. Interest rates. When applying the income approach, valuators factor interest rates into future cash flow projections and the cost of debt (a component of the company's discount rate). Recent increases in interest rates have increased the discount rates, which have lowered valuations — including the values used in M&A transactions that may be used to derive pricing multiples under the market approach.

2. Stock prices. Declining publicly traded stock prices may translate to lower pricing multiples under the guideline public company method. This technique derives value from the stock prices of comparable publicly traded companies. Under the income approach, lower stock prices may increase the cost of equity (another component of the discount rate). Higher discount rates mean higher risk and lower values.

In general, both factors have adversely affected valuations in recent years, but this isn't a foregone conclusion. Companies with proven track records of solid performance in times of economic uncertainty may be able to offset some of the negative effects. Experienced valuators consider company-specific risks and adjust their analyses to fit the circumstances. This may require subjective adjustments to discount rates and pricing multiples based on the expert's professional judgment.

indicator of future performance for companies that struggled during the pandemic.

To accurately value these companies, valuators must assess turnaround plans to project future earnings and determine whether there's a viable strategy for recovery. Absent a reliable track record of stable earnings, forecasting a distressed company's performance and assessing its risk requires a high degree of professional judgment.

Determining liquidation value

There are two premises of value. Most valuation assignments call for *going concern* value. This is the value of the business with a reasonable expectation of continued future earning power. Most financial statements — a critical input for many valuation analyses — are prepared under the going concern assumption.

However, some businesses may be worth more dead than alive. In these situations, valuators need to estimate *liquidation* value — that is, the net amount the company would realize by terminating the business and selling its assets. Depending on the circumstances, the valuator may assume an orderly or a forced liquidation. In orderly liquidations, assets are sold over a reasonable period to maximize expected return. Forced liquidations are akin to fire sales and are usually less valuable.

In some cases, the best strategy may be to continue a portion of the business and liquidate the rest. These situations call for a hybrid technique where part of the business is valued as a going concern and the rest is valued using the liquidation premise of value.

Value judgments

Experienced valuators understand the nuances of valuing distressed businesses and adjust their methodology accordingly. What's appropriate largely depends on the cause of a company's financial distress. Contact a valuation professional to determine what's right for your situation. ■

Limited time opportunity

Take advantage of the expanded unified gift and estate tax exemption

The Tax Cuts and Jobs Act (TCJA) effectively doubled the unified federal gift and estate tax exemption — and inflation has boosted it even further. For individuals who make gifts in 2023 or die in 2023, the unified exemption is $12.92 million (effectively $25.84 million for married couples). This is an increase of $860,000 per person from 2022! Unfortunately, the expanded unified exemption is scheduled to revert to pre-TCJA levels after 2025, unless Congress extends it.

It's uncertain what will happen with the tax code in the future. But private business owners should consider transferring ownership to the next generation or their favorite charities *now* — while the tax laws are favorable and business values are down because of uncertain market conditions.

Gift and estate tax basics

Under the TCJA, the federal gift and estate tax exemption per individual increased from $5 million to $10 million, with annual indexing for inflation. Taxable estates that exceed the exemption amount now have the excess taxed at a flat 40% rate.

In addition, cumulative lifetime taxable gifts that exceed the exemption amount are now taxed at a flat 40% rate. Taxable gifts are those that exceed the annual federal gift tax exclusion, which is $17,000 for 2023. If you make gifts in excess of what can be sheltered with the annual gift tax exclusion amount, the excess reduces your lifetime unified federal estate and gift tax exemption dollar-for-dollar.

Under the unlimited marital deduction, transfers between spouses are federal-estate-and-gift-tax-free. But the unlimited marital deduction is available only if the surviving spouse is a U.S. citizen.

If you make gifts of business interests to family members, loyal employees or charities today, the fair market value of those gifts may count toward your lifetime exemption — which means they would be tax-free.

For example, suppose an unmarried business owner gifts private stock to 10 family members valued at $1.17 million in 2023. After the annual gift tax exclusion is applied to $170,000 of gifts, the lifetime exemption can shelter the remaining $1 million from gift tax. That leaves an available estate tax exemption of $11.92 million (assuming the business owner hadn't tapped into the lifetime exemption in a previous year).

Important: Some states impose estate or inheritance tax at a lower threshold than the federal government does.

Value of gifts

How much is a company's stock worth today? This question needs to be answered before business owners can make gifts or donations. The answer tells how much stock can be gifted without incurring gift tax — or how much can be deducted for a charitable donation. And it helps owners formulate a long-term strategy for transferring wealth.

For gift and estate tax purposes, IRS Revenue Ruling 59-60 identifies the following eight factors to evaluate the fair market value of a private business:

1. Its nature and history,

2. The outlook for the industry and economy,

3. The company's book value and financial condition,

4. Its earnings capacity,

5. How much dividends the company could (or does) pay out,

6. The value of goodwill and other intangible assets,

7. Prior sales of the company's stock and the size of the block, and

8. The price paid in comparable stock transactions.

In addition, smaller ownership interests may be eligible for discounts for lack of control and marketability.

Do-it-yourself business valuations may raise a red flag. So, most taxpayers hire a business valuation professional to estimate value. Valuation experts use real-world empirical data to support their analyses, rather than gut instinct or industry rules of thumb.

Moving target

Volatile market conditions have adversely affected the values of businesses in many industries. Another reason to gift (or donate) business stock sooner rather than later is that it tends to appreciate in value over time. Proactive gifting strategies allow owners to transfer business interests during their lifetimes, while values are relatively low. This exposes less of their net worth to estate tax. Contact a business valuation professional to help formulate effective gifting and charitable-giving strategies for your business clients. ■

Tax Court writes new chapter in ongoing saga of "tax affecting"

In *Estate of Cecil v. Commissioner*, the U.S. Tax Court recently addressed several issues related to the valuation of noncontrolling, nonmarketable shares of S corporation stock for federal gift tax purposes. Most notably, it opined on whether "tax affecting" is appropriate when valuing interests in pass-through entities using the income approach.

The court concluded that it was appropriate under the facts of the case. But the court emphasized that it's "not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."

Valuation pros vs. the IRS

In a business valuation context, the term "tax affecting" refers to the practice of discounting the projected earnings of pass-through businesses for entity-level taxes. Unlike C corporations, pass-through entities — such as S corporations, partnerships, limited liability companies and sole proprietorships — don't pay entity-level taxes.

> ***Many valuators believe that tax affecting is appropriate to reflect the owners' individual tax burdens.***

When using the income approach to value these entities, many valuators believe that tax affecting is appropriate to reflect the owners' individual tax burdens. They assert that taxes are a critical consideration for hypothetical willing buyers when evaluating an investment. In addition, the data used to value pass-through entities is largely derived from C corporations. So, proponents of tax affecting believe that it's necessary to adjust for the "mismatch from pretax cash flows and after-tax discount rates."

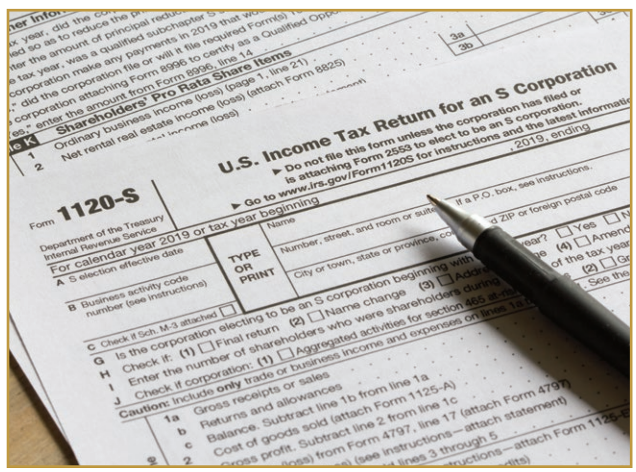
On the flip side, the IRS has consistently challenged tax affecting — and the Tax Court has generally sided with the IRS. For instance, in *Gross v. Commissioner*, the court reasoned that tax affecting ignored the primary benefit of S corporation status: the absence of corporate-level taxes. The Tax Court maintained this stance in several cases in following years.

However, there's one exception: In *Estate of Jones*, the court accepted the valuation of an S corporation by the estate's expert. The expert had tax affected earnings using an assumed 38% combined federal and state tax rate and then added a premium to reflect the benefits associated with avoiding entity-level taxes. The court found that the estate's expert — by considering both tax costs and benefits — had more accurately accounted for the tax consequences of pass-through status than the IRS expert who failed to tax affect.

Recent decision

In *Cecil*, the Tax Court was influenced by the fact that both experts had tax affected the S corporation's earnings. Both experts also adjusted the resulting values by applying the S corporation equity adjustment multiple (SEAM) model. This model adjusted the C corporation equivalent value produced by tax affecting to reflect the tax advantages of a pass-through entity. In this case, the estate's expert applied a 24.6% rate while the IRS's expert applied a 17.6% rate. The court accepted the lower rate without explaining its reasoning.

Depending on the relative tax rates used, the SEAM model may result in a premium, a discount, or equivalent S corporation and C corporation values. The transactions in *Cecil* took place before the Tax Cuts and Jobs Act slashed corporate income tax rates, so it's likely that the model would produce different results today.



What's next?

Cecil didn't result in a blanket endorsement of tax affecting. But it suggests that the Tax Court may be receptive to tax affecting, at least when it's supported by expert testimony and valuation methods that account for both the tax costs and benefits of pass-through status. ■

Couple lets judge value their top marital asset

Absent expert testimony, court values interest in professional practice

The Court of Appeals of North Carolina recently upheld a trial court's valuation of the wife's interest in a dental practice for equitable distribution purposes. Neither spouse in *Logue v. Logue* offered expert testimony. However, the appellate court found that the trial court's market-based valuation approach, while "rudimentary," was "sufficiently reliable to reasonably approximate the value of [the wife's] stake in the business."

Wife takes a bite out of dental practice

The couple married in 2004, and the wife joined a father-and-son dental practice in 2009. In December 2012, the wife (through her wholly owned S corporation) acquired the father's 50% interest in the practice for $1,249,800. The purchase was 100% financed with bank loans.

The purchase price was determined by a professional appraisal, which included $1,018,800 in goodwill, based largely on the father's reputation in the community. After the sale, the father continued to work in the practice, eventually reducing his workload to two days a week. The couple separated in February 2015 and divorced in July 2016.

Trial court fills in valuation gaps

Neither spouse hired a valuation expert, so the trial court performed its own valuation of the wife's interest in the practice on the separation date. It applied a market-based approach, starting with the price the wife paid for her interest two years earlier in an arm's-length transaction.

Next, the court examined the practice and determined that there weren't any changes in the intervening period that had a significant impact on market value. Specifically, it found no evidence that goodwill — which continued to be valued at $1,018,800 on the financial statements — had changed. The appellate court found this conclusion reasonable, considering that the father continued to work in the practice and the wife had been developing her own clientele. The trial court added the value of the wife's share of other assets to goodwill and subtracted the outstanding loan balance to arrive at a net value of $195,395 on the separation date.

The appellate court rejected the wife's argument that the trial court erred by determining goodwill without the benefit of expert testimony. Although such testimony may be required for a court to calculate goodwill "in the first instance," it was appropriate for the court to find that goodwill previously calculated by outside experts remained applicable.

Hiring outside experts

The trial court's valuation approach was rudimentary. But the appellate court found it sufficiently reliable, "particularly in light of both parties' choice not to retain experts … that would permit the court to engage in more sophisticated valuation methodology." If the parties had engaged valuation pros, they might have had more say in the outcome. ■

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415 Sargon Way • Suite J • Horsham, PA 19044
Tel: (215) 675-8364 • Fax: (215) 675-3879
www.wm-cpa.com

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- Criminal Tax Matters
- Valuing Closely Held Businesses
- Purchase or Sale of Business
- Succession Planning
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