Valuations in the Transfer
of Family Businesses

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I. Business Valuation - Art or Science?
A. Scientific Aspects
   1. Gathering Empirical Evidence
   2. Error Rate Analysis
   3. Database Manipulation
   4. Reasoned Conclusion With Probability
B. Subjective Factors
   1. Risk Assessment
   2. Selection of Comparables
   3. Growth Projections
   4. Importance of Venue
   5. Weighting of Factors and Methods
C. Competitive Aspects
   1. Independence
      a. Advocacy of One’s Position
      b. Advocacy of One’s Client
   2. Competence
   3. Reasonable Reliance
   4. Head-to-Head Comparisons
   5. Nonlitigious Beginnings
   6. Judicial Findings and Precedents
D. Internal Revenue Service Requirements
   1. Qualified Appraisal
   2. Qualified Appraiser
II. Basics of Business Valuation

A. Motivating Events

1. Purchase or Sale of Business to Third Party
2. Divorce
3. Buy-Sell Agreement
   a. Drafting
   b. Execution
4. Business Disputes and Litigation
5. Taxable Transfers
   a. Income/Compensation
   b. Gift
   c. Estate
   d. Charitable
   e. Insurance

B. Key Concepts and Terms

1. Expected Return on Investment
   a. Discounted Future Cash Flow (Income Approach)
      i. Discount And Capitalization Rate
      ii. Capital Asset Pricing Model (CAPM)
      iii. Build-Up Method
      iv. Estimated Terminal Value
   b. Capitalized Current Earnings (Market Approach)
      i. Preferred Approach By Internal Revenue Service
      ii. Valuation Multiples From Comparable/Guideline Companies
      iii. Non-Cash Flow Income Variables
         a) EBIT
         b) EBITDA
         c) Sales
         d) Net Income
         e) Discretionary Earnings
         f) Pre-Tax Income
   c. Liquidation Value (Underlying Asset Value Approach)
   d. Market Comparables/Guideline Companies
      i. Price/ Earnings Ratio
      ii. Rules of Thumb

2. Discount/ Capitalization Rate (Time Value of Money)
   a. Capital Asset Pricing Model (CAPM)
      1) Empirical Observations of Cost of Capital
      2) Large Caps vs. Small Caps
      3) Minority Discounts
      4) Growth Assumptions
II. Basics of Business Valuation (continued)

b. Build-up Method
   1) Risk-Free Rate
   2) Risk Factors
      a) Size
      b) Economy
      c) Industry
      d) Company

c. Relationship of Discount and Capitalization Rate

d. Valuation Date

3. Definition of Value

a. Fair Market Value (Rev. Rul. 59-60)
   1) Controlling Interest
   2) Minority Interest
   3) Marketable v. Nonmarketable

b. Fair Value

c. Liquidation vs. Going-Concern Value

d. Investment Value

e. Contractual Value

f. Special Purpose Value

4. Premiums and Discounts

a. Control Premium

b. Swing Vote Premium

c. Minority Interest Discount

d. Lack of Marketability Discount

e. Blockage Discount / Market Absorption

f. Thin Management Discount

5. Goodwill and Intangibles

a. Single Asset Purchase

b. Multi-Asset Purchase (IRC Sec. 197)

6. Forms of Business Entity

a. Corporation

b. Professional Corporation

c. S Corporation
   i. Market Approach Without Taxes
   ii. Income Approach With Income Taxes

d. General Partnership

e. Limited Partnership

f. Limited Liability Partnership

g. Proprietorship

7. Tax versus Non-Tax Business Valuations

a. Tax Advocate

b. Purchaser

c. Seller

d. Expert Witness
II. Basics of Business Valuation (continued)

C. Application to Various Types of Businesses

1. Capital Intensive Businesses
   a. Manufacturing
   b. Wholesalers
   c. Retailers
   d. Construction Contractors

2. Service Businesses
   a. Pre-Set Price Contract Providers
   b. Hourly / By Project
   c. Percentage Of Benefit

3. Combination Businesses

4. Professional Practices In Louisiana
   a. Depner v. Depner (Dentist), LA. Court of Appeal, First Circuit
   b. Due v. Due (Plaintiff Attorney), LA. Supreme Court

5. Oil and Gas
   a. Producing
      1) Royalties
      2) Working Interest
   b. Non-Producing
III. Recent Developments in Business Valuations
   A. Tax-Related Valuations

   a. Decedent Owned 50% Interest In Closely Held Corporation
   b. 10% Discount For Minority Interest Allowed For Negative Control

2. Eisenberg v. Comm., (U.S. Court of Appeals, Second Circuit, August 18, 1998)
   a. Discount Allowed From Net Asset Value For Capital Gains Taxes On C Corp With Primarily Commercial Real Estate Even Without Liquidation Plan
   b. Follows And Cites Estate of Davis v. Commissioner (110 TC No. 35 (1998))
   c. Overturns And Remands Tax Court Decision
   d. 35% Lack Of Marketability Discount Increased to 50% (15% For Capital Gains Tax)–Real Rate?
   e. Government’s Expert Proposed 23% Discount
   f. Tax Court Considered Both Restricted Stock Studies And Pre-IPO Discount Studies
   g. 1986 Repeal Of General Utilities Doctrine Key To Decision

   a. Real Estate Owned By Corporation Condemned By Government
   b. Court Disallowed Discount For Capital Gains Tax
   c. Tax Could Be Avoided By Timely Replacement

   a. Appeals Court Found Buy-Sell Agreement Controlled Valuation
   b. Court Found That Decedent’s Heirs Not Benefited

   a. IRS Conceded 15% Blockage Discount
   b. Appeals Court Allowed 20% Discount For Lack Of Marketability Using So-Called Moment Of Death Value
   c. Affiliate Status Not Changed By Death

6. Internal Revenue Service Technical Advice Memorandum 97-19006
   a. Family Limited Partnership Ignored For Estate Valuation
   b. Transfer 18 Days Prior To Death

7. Chapter Q Of Internal Revenue Service Continuing Professional Education Textbook Concerning Valuation Of Medical Practices
III. Recent Developments in Business Valuations (continued)
   A. Tax-Related Valuations (continued)
      a. Valuation Of General Partnership Interest In Commercial Real Estate Lessor
      b. 19% Minority Interest Discount Allowed
      c. 26% Discount For Lack Of Marketability Allowed
      a. Undeveloped Land
      b. 44% Discount For Undivided Partial Interests In Real Estate (30%/20%)
      c. Successive Discounts For Minority Interest and Lack Of Marketability
   9. **Estate of Barge v. Comm.** (T.C. Memo 1997-188)
      a. Income-Producing Land
      b. Only 10% Discount Rate Used By Court
   10. **Estate of Brookshire v. Comm.** (U.S. Tax Court, October 8, 1998)
       a. 40% Lack Of Marketability Discount Applied By Tax Court (Highest Yet)
       b. Taxpayer’s Expert Urged 45%
       c. Government’s Expert Proposed 34%
   11. **Estate of Bosca v. Comm.** (U.S. Tax Court, July 8, 1998)
       a. Gift By Father Of 50% Interest To Two Sons Who Owned 25% Each
       b. Single Block Of Stock Or Two
       c. Court Held Two Blocks Of 25% Each
       d. 2.72% Premium Rather Than 25.62% Used
       a. Accounting Firm Liquidated And Distributed Assets
       b. Petitioner Alleged Goodwill Had No Value And Was Not Corporate Asset
       c. Government Alleged Goodwill Had Value
       d. Government’s Expert Assumed Covenant Not To Compete Was In Effect, But It Was Not
       - Nestle Holdings, Inc. vs. Comm., CA-2 July 31, 1998
       - Auker Estate v. Comm., TC Memo 1998-185
   14. Form 709 Box Regarding Use Of Valuation Discount
   15. 1997 Tax Act
III. Recent Developments in Business Valuations (continued)

B. Precedent Setting Tax Valuation Cases

   a. Blueprint Of A Business Valuation
   b. Judge Approved 30% Discount

2. **Jane O. Kosman v. Comm.** (T.C. Memo 1996-112)
   a. Application And Amount Of Discounts
   b. Use Of Multi-tiered Or Layered Discounts
   c. Use Of Guideline Public Companies
   d. Use Of Prior Transactions In Valuation

   a. Documentation Of Discount Required
   b. Factors Supporting Opinion Disclosed

   a. Taxpayer’s Expert Did Not Consider Market Approach
   b. Stock Sold At IPO For $10 Per Share
   c. Estate Valued Stock At $1.02 Per Share

   a. Prior Court Opinions Not Sufficient To Support Opinion
   b. Conclusions Regarding Value Must Be Adequately Supported

   a. Valuation Of Stock Of Personal Holding Company
   b. Three Valuation Approaches Used
   c. Weights Were Applied To Compute Average

   a. Court Allowed 40% Discount For Lack Of Marketability
   b. Shareholder Agreement Restricted Stock Transfers

   a. Valuation Of 200 Parcels Of Real Estate In New York City
   b. Value Determined By Reference To Donor And Not To Donee
   c. Discount For Lack Of Control Should Be Based On Costs Of Partition

   a. Subsequent Events Confirm Valuations But Do Not Affect Them
   b. Subsequent Sales Of Comparable Properties Useful Indicators
C. Non-Tax Business Valuations
      a. Two Issues Regarding Admissibility Of Evidence
         1) Is Proffered Evidence Scientific Knowledge?
         2) Will The Evidence Proffered Assist The Trier Of Fact With A Fact At Issue?
      b. The Four Daubert Questions
         1) Whether The Theory Or Technique Can Be Or Has Been Tested?
         2) Whether The Theory Or Technique Has Been Subjected To Peer Review And Publication?
         3) What Is The Known Or Potential Rate Of Error?
         4) Has There Been General Acceptance Of The Theory Or Technique?
      a. Involved withdrawal of partner from limited liability partnership
      b. Issue involved applicable discounts (minority interest and lack of marketability)

D. Proposed Legislation And IRS Initiatives
   1. President’s 1998 Tax Proposal For Elimination Of Discounts From Net Asset Value For Family Limited Partnerships And LLC Holding Companies
      a. Not Universally Applied
      b. Prospective Only?
   2. Proposed Phase-out Of Estate And Gift Taxation
   3. Proposed Reduction Of Capital Gains Tax
   4. IRS Announces Increased Scrutiny Of Gift And Gift Tax Returns
      a. Major Concern Is Valuation Discount For Family Limited Partnerships (FLP) And FLLC
      b. 14% Of Estate And Gift Tax Returns Being Examined Involve FLPs

IV. Professional Literature
   A. Consulting Services Practice Aid 96-3, Communicating in Litigation Services: Reports. A Nonauthoritative Guide
   B. Shannon Pratt’s Business Valuation Update, Business Valuation Resources, L.L.C.
   C. Roger Grabowski and David King (Price Waterhouse), Study of Historical Equity Risk Premiums: Averages Since 1963
   D. Done Deals, John Bailey


G. American Institute of CPAs, Statement on Standards for Valuation Services No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset (June 2007)

V. Impact of Income Taxes on Business Valuations
      1. Net Asset Value Approach Used To Value Corporation That Owned Ranch
      2. 20% Discount For Lack Of Marketability Allowed
      3. No Discount Allowed For Partition Costs
   B. Estate of Stewart B. Kett, T.C. Docket No. 1742-94
      1. 40% Discount Allowed For C Corp Net Asset Value To Reflect Capital Gains Tax
      2. Case Settled And Of Questionable Value

VI. Rules for Transfer of Assets in Community Partitions
   A. Transfers of Property Between Spouses or Incident to Divorce (IRC Section 1041)
      1. No Gain or Loss Recognized to Transferor
      2. Transfer Treated as Gift with Carryover Basis
      3. Transfer Incident to Divorce if -
         a. Within one year of cessation of marriage, or
         b. Related to the Cessation of Marriage
      4. Transfers in Trust Where Liability Exceeds Basis
   B. Transfers Not Incident to Divorce
      1. Stock Redemptions
      2. Buy / Sell Agreements
      3. Subsequent Transfers

VII. The Business Appraiser’s Library
   A. Periodicals
      1. CPA Expert - AICPA Newsletter for Providers of Business Valuations & Litigation Services
      2. Shannon Pratt’s Business Valuation Update, Business Valuation Resources, L.L.C.
   B. Books and Subscriptions
      1. Cost of Capital Quarterly, Ibbotson Associates
      4. Internal Revenue Service Valuation Guide for Income, Estate, and Gift Taxes
5. Federal Civil Judicial Procedure and Rules, West Publishing Company
7. Internal Revenue Service Valuation Training For Appeals Officers Coursebook

C. CD ROM or Diskette
   1. Annual Statement Studies, Robert Morris Associates (National and Regional Editions)
   2. Done Deals, John Bailey

D. On Line
   1. Business Valuation Update Online, NVST Journal Subscriptions
   2. Electronic Data Gathering and Retrieval (EDGAR), Securities and Exchange Commission
   3. Federal Reserve Bank of St. Louis (FRED)
   4. United States Census Bureau
   5. Compustat
   6. Mergistat
   7. Dow Jones News Retrieval
   8. Lexis/Nexis and Westlaw
   9. Big 5 Accounting Firms’ Home Pages
   10. Business and Industrial Associations Home Pages

E. Authoritative Literature
   1. AICPA Code of Professional Conduct
   2. Uniform Standards of Professional Appraisal Practice (USPAP), Appraisal Standards Board (Revisions Finalized)
   3. Treasury Revenue Ruling 59-60; Valuation Of Stocks And Bonds
   4. Treasury Revenue Ruling 68-609; Determination Of Amount Of And Recognition Of Gain Or Loss