KTS

VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC. 2010-2

SELLER EMOTIONS

Prepared by: Roger L. Neu, JD, Principal, The M&A Law Firm

Selling a business that you have owned for several decades, or that has been in the family for several generations, can produce some pretty strong emotions. Generally those emotions will run the whole gamut from "couldn't be happier to get rid of all the headaches" to "why did I ever think of giving up something I have worked so hard to build and has been so good to me and my employees."

After recently closing a successful sales transaction, my client said he understood why I had told him, on several occasions, that selling a business is a "process" and not an "event." He expressed his gratitude for guiding him through that process. Clients need to feel secure in the decisions they are making at such a critical juncture in their lives. My role is to make sure clients have all the information they need, understand their alternatives and know the likely outcomes of different scenarios so they can make the right decisions.

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Preparing the client, at the outset, for what lies ahead in the sale process can knock down a lot of the emotional difficulties that could otherwise come up. I take great care to try to really understand what clients are thinking and feeling before the process begins. Uncertainty in a sale process can lead to additional stress and heightened emotions. Throughout the sale process, I communicate with my clients to make sure they understand what steps are being taken and why they are being taken. Clients should not feel rushed. They should always feel like they fully understand all the issues and the manner in which those issues are resolved. Eliminating uncertainty eliminates a lot of stress and emotion.

"I take great care to try to really understand what clients are thinking and feeling before the process begins. "

Consideration for "Seller's emotions" should be kept front and center throughout the sale process. Heart surgery is a very invasive surgical procedure and the sale process is very invasive business procedure. Just as recent studies show that heart surgery can take a tremendous emotional toll if the heart is not handled properly; a business sale can be an emotional train wreck if not handled properly. I make sure the emotional train stays on the track not only for the well-being of my clients, but for the ultimate success of their sale transaction. Clients should reap the economic rewards they deserve, as well as feel emotionally satisfied with the transaction that is the capping moment of many years and/or many generations of hard work. ❒

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The M&A Law Firm was founded by Roger L. Neu, JD, Principal, in 1982 to provide specialized M&A legal services to privately held middle market companies ($5M to $250M). Mr. Neu was a CPA with PriceWaterhouse Coopers, graduated from Loyola Law School with honors and has advised over 250 clients in M&A transactions. The M&A Law Firm believes that privately held middle market companies should have the best representation at every step in the M&A process to achieve maximum value.

BUILT-IN CAPITAL GAINS - Davis to Jelke Case

By: John A. Thomson, ASA, MAI, VP/Managing Director, Los Angeles office

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In 1997, the tax court issued its opinion on Eisenberg (TC Memo 1997-483). The issue was relative to a discount for built-in capital gains on a "C" corporation holding real estate. There was no intention to liquidate the company. The tax court disallowed any discount for built-in capital gains tax as the tax liability itself is deemed to be speculative.

Then comes the Davis case in 1998 (in which KTS testified for the Internal Revenue Service "IRS") (110 TC. No.35) in which the court did allow some consideration for built-in capital gains based on the willing buyer and willing seller concept (double taxation "C" corporation). The court allowed approximately one-third of the total capital gains tax as a discount, built into the marketability discount (13 percentage points added to the marketability discount).

In 1998, Eisenberg is appealed to the second circuit (1998) and remanded to the tax court based on the Davis case to allow for some consideration for built-in capital gains[1].

The second circuit essentially said that you must take built-in capital gains into account even if there is no evidence that the company will be sold in the near future. The amount of built-in capital gains is based on the appraiser's opinion as to what a willing buyer and willing seller would negotiate. This can be done by present valuing the tax or some other supportable method.

In 1999, the Jameson tax court decision was based on the tax court's calculation of the built-in capital gains. It stated that the IRS expert appeared to be an advocate and that Judge Gale did not care much for the taxpayer's experts. The decedent owned 98 percent of the stock of an operating timber company and investment company. The tax court, based on the Davis case, concluded that some discount for built-in capital gains should be given. Using a net asset valuation approach, the tax court allowed a partial discount based upon the court's estimate of the net present value for the capital gains tax liability on the timber property that would be incurred as the timber was cut over a nine-year period. The court allowed no consideration for built-in capital gains on the investment company.

In 2000, in the Estate of Dunn, Judge Gale allowed a 5 percent reduction for built-in capital gains in the asset-based approach to value for a 62.96 percent interest in an operating equipment company. The company was valued by an earnings-based approach (35 percent weight) and an asset-based approach (65 percent weight).

In 2001, the fifth circuit (Jameson) concluded that the tax court had clearly erred in crafting its own valuation. The fifth circuit vacated the judgment and remanded the case back to the tax court to reconsider the amount of built-in capital gain's on the operating timber property and to consider and to allow a discount for the built-in capital gains on the investment property.

In 2002, the fifth circuit in the Estate of Dunn disagreed with the tax court under the net asset valuation approach. The fifth circuit held, as a matter of law, that as a threshold assumption, liquidation must always be assumed when calculating an asset value under the net asset value approach. The fifth circuit concluded that the value of the assets must be reduced by a discount equal to 100% of the capital gains liability (dollar-for-dollar).

The fifth circuit appeared to focus heavily on the willing buyer essentially leaving the willing seller out of the equation.

In 2005, it's the Estate of Jelke. This case involved a 6.44 percent interest in a closely held "C" corporation whose assets consisted primarily of marketable securities. The tax court held that the built-in capital gains tax liability should be discounted (less than dollar-for-dollar) to reflect when it is reasonably expected to be incurred.

In 2007, the eleventh circuit opinion on Jelke states the following, "We are in accord with the simple yet logical[2] analysis of the tax discount valuation issue set forth by the fifth circuit in the Estate of Dunn, 301.F.3d at 350-55, providing practical certainty to tax practitioners, appraisers and financial planners alike. Under a de novo review, as a matter of law, we vacate the judgment of the tax court and remand with instructions that it recalculate the net asset value of Commercial Chemical Company ("CCC") on the date of Jelke's death and his 6.44% interest, therein, using a dollar-for-dollar reduction of the entire \$51 million built-in capital gains tax liability of CCC, under the arbitrary assumption that CCC is liquidated on the date of death."[4]

The eleventh circuit goes on to state, "The tax court distinguished the majority interest held by the decedent in the Estate of Dunn from our case on the basis that the Jelke estate's minority interest was single-handedly insufficient to "force liquidation on its own."

"This distinction is not persuasive to us. We are dealing with hypothetical not strategic willing buyers and willing sellers."[4]

"As a threshold assumption, we are to proceed under the arbitrary assumption that a liquidation takes place on the date of death."

In the Jelke case, the dissenting opinion by Judge Carnes is very interesting and worth reading. Some comments from his dissenting opinion follow, "The tax code is nowhere near the center of my intellectual life, and generally I find estate law about as exciting as Hegel's metaphysical theory of identity of opposites. There is, however, more involved in this case than just the estate tax issue presented, which is how to determine the fair market value of the decedent's distinctly minority interest in CCC, a closely held corporation[6] whose assets consist primarily of marketable securities with a built-in capital gains tax liability."

"The majority gives in to judicial equivalent of the doctrine of ignoble ease. To avoid the effort, labor, and toil that is required for a more accurate calculation of the estate tax due. The majority simply assumes a result that we all know is wrong. We can do better than that. The tax court did."

"The tax court adopted the IRS's real value approach, even though it is more complicated than the estate's simple but arbitrary assumption that all of the assets were sold at the time of death. The court chose the real value approach because it produces a result closer to the actual value of the company's assets, which in turn leads to a more accurate determination of the sales price a willing buyer and willing seller would agree on for the shares of the holding company that Jelke owned on the date of his death."

"While the real value approach is not perfect in itself and it makes some assumptions, such as the post rate of liquidation continuing in the future, it produces a more accurate result than the arbitrary assump-

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tion method because it more closely reflects the economic interests of those who control the company, that has been producing an average annual rate of return of more than 23 percent on securities, and that has substantial built-in capital gains taxes, is not going to prompt the liquidation of all of the company's assets. It would be economically foolish for the majority shareholders to gut the golden goose and bring down on their heads the embedded capital gains tax liability simply because of the death of a minority shareholder, an event of no relevance to their economic interests."

"The death of a human being is profoundly important to that person who dies but it matters not one whit to the laws of economics, which dictate the self interest of the living. Because the interests of the majority shareholders did not change when Jelke died, the only reasonable expectation is that the holding company will continue to be run as it was before that immaterial event occurred. Yet the majority insists on pretending that contrary to the economic interests of its shareholders and contrary to everything that has come before, the company must be assumed to have sold all of its securities on the date of Jelke's death."

"The majority suggests that subtracting the entire $51 million in embedded capital gains liability from the $188.6 million value of the company's portfolio is the best approach, because "why would a hypothetical willing buyer of CCC shares not adjust his or her purchase price to reflect the entire $51 million amount of CCC's built-in capital gains tax liability?" The answer, of course is that the buyer would adjust downward the price he was willing to pay in order to reflect that liability, but the buyers could not reasonably expect the seller to agree to a price that ignored completely the time value of money. No rational seller would accept a price that subtracted the entire amount of the future tax liability as though it were due immediately when that liability will almost certainly be spread out over future years instead, the next 16.8 years if existing practices continue. Assets with liabilities that will not come due until future years are worth more than those with the same amount of liabilities that are due immediately."

"Ask yourself: if you had the choice would you prefer to pay the taxes you are going to owe over the next 16 or so years in advance, right now, or would you choose to pay those taxes only when they come due in the future? The majority would assume, because it makes the calculations easier, that you would choose to pay all of your future taxes now."

Obviously, the eleventh circuit court decision was very controversial. It will carry some weight in future cases in the eleventh circuit only (Florida, Georgia and Alabama). It is important to point out that it related to a "C" corporation with marketable securities, not to pass thru entities or "C" corporations holding for example real estate.

Unfortunately, what is missed from the Davis case to the Jelke case is finding a method to quantify the discount relative to the built-in capital gains exposure when the "C" corporation possessed marketable securities without projecting future trends. Klaris, Thomson & Schroeder, Inc. ("KTS") did just this in the Davis case which was overlooked in our opinion.

In the Davis case, KTS used the publicly traded closed-end funds and their respective discounts from their net asset value. This discount is normally used to assist the valuation analyst quantify the lack of control discount to apply to the NAV of a company holding marketable securities if applicable. This is because the closed-end funds are publicly traded and thus marketability is not an issue. However, each of the closed-end funds reports their exposure to built-in capital gains along with their discount. KTS found no direct correlation between this size of the discount, the fund traded at, and the magnitude of its built-in capital gains exposure (up to a maximum of 50%). In other words, investors appeared somewhat indifferent to the built-in capital gains exposure up to the maximum displayed by the closed-end funds as of the date of the appraisal. Above that maximum, KTS allowed dollar-for-dollar consideration (above 50% of the built-in capital gains exposure). This essentially equated to approximately one-third of the built-in capital gains (one-third of the total dollar-for-dollar on 100% of the exposure). This equated to 15 percentage points ($10.0 million) added to the marketability discount in the KTS report. The court decided it should be $9.0 million or 13 percentage points added to the marketable discount.

The KTS method was simple, market driven, and focused both on the willing buyer along with the willing seller. This is contrary to the eleventh circuit's majority decision that focused primarily on the buyer and made arbitration assumptions contrary to the facts and circumstances in the interest of keeping it simple for the courts.

The Jelke case consists primarily of marketable securities and the argument put forth (besides the arbitrary assumption of liquidation for ease of calculation) is that a willing buyer would not pay the same price for these marketable securities in the subject "C" corporation (emphasis on "C" corporation) versus buying the securities directly. This is true, that is why the Davis case occurred.

However, would a willing seller reduce his value dollar-for-dollar? This is very doubtful. Also, this argument does not hold water when the underlying assets are other then marketable securities, such as real estate. You can't go outside the corporation and buy the subject real estate. You would have to buy different (possibly similar) real estate.

Finally, we note that the overall discount in the Jelke case for a 6.44 percent interest in a company holding marketable securities was 62 percent. Certainly this fails the sanity test of the tax court based on prior decisions and/or the test of reasonableness based on Revenue Ruling 59-60.

This was a home run for the willing buyer and a strike out for the willing seller. It appears that the fifth and eleventh circuits are supporting dollar-for-dollar discounting when the net asset value approach is used. The second and sixth circuits are something less than dollar-for-dollar. On the other circuits, time will tell. ❒

1. The sixth circuit in Welch appears similar to the second circuit, something less than dollar-for-dollar as would be negotiated by a willing buyer and a willing seller. 2. This is highly disputed by making arbitrary assumptions and leaving the willing seller out of the logic. 3. In the Estate of Dunn dollar-for-dollar deduction for built-in capital gains was only taken on 65 percent of the total value. As 65 percent was the weighting given to the NAV approach. The other 35 percent weighting was given to the income approach where no consideration for built-in capital gains was considered. 4. If the majority (2 judges) were looking for a simple way to quantify the tax impact on the market, they could have arbitrarily assumed no liquidation and no tax paid. This of course goes back to pre Davis case thinking. 5. If you are to arbitrarily assume liquidation even though a minority interest could not by itself cause liquidation why then do you take an additional 20 percent discount for lack of control? 6. "C" corporation.

Mr. John A. Thomson is the Vice President and Managing Director of the Los Angeles office of Klaris Thomson & Schroeder Inc. and has over 34 years of valuation experience. Mr. Thomson has his ASA in Business Valuation and Intangible Assets, a MBA in Finance, and his MAI in Real Estate. He has his undergraduate degree in engineering and has been a speaker on numerous valuation topics to various groups, associations, CPA firms, and law firms. In addition, he has extensive expert testimony experience.

KTS CALENDAR

05/12/2010	**Presentation - St. Louis Business Valuation Roundtable/ASA Luncheon, St. Louis, MO - "Reviewing & Working for the IRS & Valuation Issues in Estate Planning & Gift Tax" John A. Thomson, ASA, MAI & Gary Schroeder, ASA, speakers.**
06/16-20/2010	**ACTEC (American College of Trust and Estate Counsel) - 2010 Summer Meeting, St. Louis, MO, - Klaris, Thomson & Schroeder, Inc. sponsorship of 2 tours and information booth.**

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For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to ktsinc@verizon.net.

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"Many of life's failures are people who did not realize how close they were to success when they gave up."
– Thomas Edison

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