Business Valuation Update for CPA's

TCOSCPA

November 19, 2014

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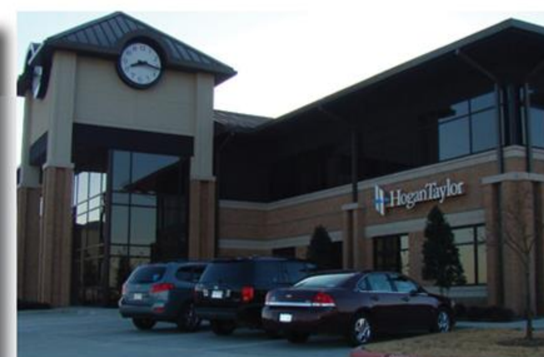
About HoganTaylor

HoganTaylor is the largest CPA firm in the Oklahoma/Northwest Arkansas region with nearly 200 professionals and employees, including 29 partners.

HoganTaylor has Offices in Oklahoma City, Tulsa and Fayetteville.



History and Future

1981	1990	2001	2009	Today
Hogan & Slovacek (H&S) began providing superior client service in Tulsa and Oklahoma City	Tullius Taylor Sartain & Sartain (TTS&S) began in Tulsa with a mission to help its clients and people achieve their goals	TTS&S expanded to serve northwest Arkansas with the opening of an office in Fayetteville	January 1, 2009, these two outstanding firms merged to form one of the region's largest independent accounting firms: HoganTaylor LLP	Our combined resources allow us expanded abilities to serve new industries, to stay on the leading edge of technology and trends, to focus on new services that add value to our clients

What We Do

HoganTaylor is comprised of professionals who continually demonstrate they are adept at providing services that are on time and well managed to a wide range of business types and specialized industries

- Tax
- Assurance
- State & Local Taxes
- Financial Management Services
- EBP Audits
- Business Valuation
- Litigation Support
- Wealth Management

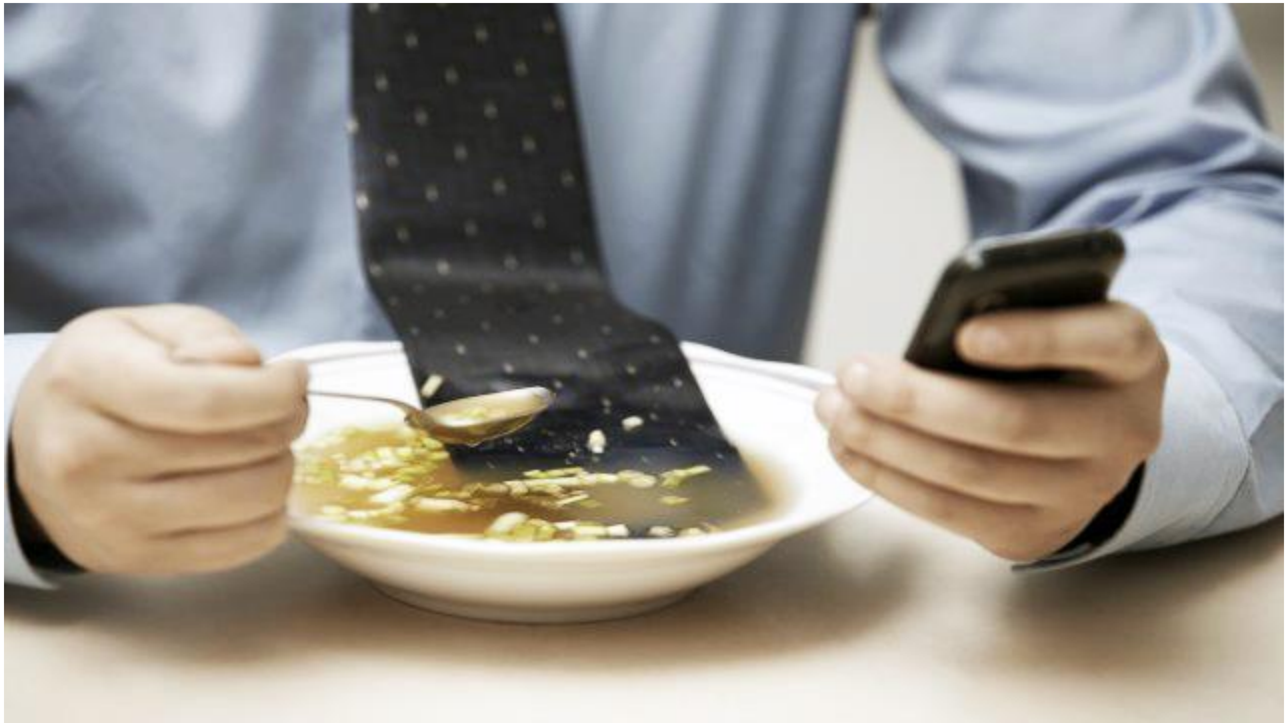
Who We Serve

As a premier Oklahoma and northwest Arkansas based firm, HoganTaylor's reputation for providing timely, quality professional service has resulted in relationships with many premier clients of various sizes operating in a wide range of industries.

- Construction
- Employee Benefit Plans
- Financial Institutions
- Healthcare
- Insurance
- Investment Funds
- Manufacturing & Distribution
- Not-For-Profit /Government
- Oil & Gas
- Private Foundations
- Public Companies (PCAOB registered)
- Retail
- Transportation

The Real Harm in Multitasking

Dr. Travis Bradberry



Multitasking

- Lowers IQ
- Causes brain damage
- Slows you down and decreases quality of work

Objectives

- Standards and Regulations
- Tax Effecting Pass-Through Entities
- Built-in Capital Gains Adjustment
- Family Limited Partnerships – Estate and Gift
- Valuing Personal Goodwill

Adherence to SSVS No. 1

- Who must follow SSVS1?
  - All AICPA members if:
    1. Engaged to estimate value
    2. The work culminates in a conclusion or a calculation of value; or
    3. Valuation approaches and methods are applied in conjunction with professional judgment

Adherence to SSVS No. 1

- ABV – Accredited in Business Valuation (AICPA)
- CVA – Certified Valuation Analyst (NACVA)
- ASA – Accredited Senior Appraiser (American Society of Appraisers)

Statute of Limitation on Adequate Disclosure

- The IRS cannot revalue a transfer after the expiration of the 3 year statute of limitations (26 U.S. Code § 6501).

- What starts the clock?
  - –Adequate disclosure

Statute of Limitation on Adequate Disclosure

Adequate disclosure is made if the return contains:

1. A description of the transferred property and any consideration received;
2. The identity and relationship between transferor and transferee;
3. A detailed description of the method used to determine the fair market value of the property transferred

26 CFR 301.6501(c)-1(e)(1),(2)

Qualified Appraiser

1. Designated from a recognized professional appraiser organization or otherwise meets regulations prescribed;
2. Regularly performs appraisals for compensation; and
3. Meets all other required regulations

Penalties to the Taxpayer

- 26 U.S. Code § 6662:
  (a) Penalty of 20% of the portion of the underpayment added to tax payable.

See *Estate of Richmond T.C. Memo 2014-26*

Penalties to the Taxpayer

- § 6662(g)(1)- substantial understatement

  the value of property claimed is 65% or less of the amount determined to be the correct valuation.

- § 6662(h)–gross valuation misstatement

  penalty increases to 40% when property claimed is 40% or less of the amount determined to be the correct valuation

Penalties to the Appraiser

- 26 U.S. Code § 6695A: Substantial and gross valuation misstatements attributable to incorrect appraisals
- 26 U.S. Code § 6662:
  - (g)- substantial estate or gift tax valuation understatement
  - (h)- increase in penalty in case of gross valuation misstatements

  Penalty is lesser of 1) the greater of 10% of the underpayment, or $1,000; or 2) 125% of the gross income received by the appraiser for the appraisal services.

Tax Effecting Pass-Through Entities

- S Corporations
- Partnerships
- Limited Liabilities Companies
- Complex Family Limited Partnerships

Tax Effecting Pass-Through Entities

- Theory:

  Businesses held out as S-corps have a higher value than C-corps because the taxes pass-through the entity level and are applied only at the individual level.

Gross v. Commissioner (1999)

- IRS refuses tax effecting pass-through entities for the first time

- IRS has not changed their position on the issue since the holding of this case
  - However, most practitioners still tax effect due to the hypothetical buyers' consideration of potential tax implications of purchase

Built-in Capital Gains Adjustment

- Valuation options:
  - Dollar for dollar deduction?
  - Estimate sale date to calculate present value taxes?
  - Build in to discount for lack of marketability?

Estate of Davis (1998)

"…a hypothetical willing seller and willing buyer…would not have agreed on that date on a price…that took no account of [the entity's] built-in capital gains tax."

-Court rejected 100% deduction

-instead it applied 15 additional percentage points to DLOM

Estate of Jelke (2007)

- "The asset approach assumes a sale, therefore you must take the full discount."
  - This is the 100% approach to BICG tax effecting

Estate of Richmond (2014)

- Valuation method:
  - Court rejected income approach, in this instance, stating that the majority of the Company's assets were interests in publicly traded stock.
  - Net asset Value was appropriate:

    The actual market prices of the publicly traded securities…[are] the most concrete and reliable data of value… Therefore, the NAV approach…starts out on 'firm ground', with stock values one can simply look up.

Estate of Richmond (2014)

- Built in capital gains (BICG) liability is *not* debt that immediately reduces the value of the Company. Therefore, the hypothetical buyer is not as concerned about BICG liability when purchasing.
- A dollar for dollar discount was not adopted as the potential BICG liability is not the same as an accrued liability due immediately.

Family Limited Partnerships

- Death bed transfers
- Retained use by a donor
- Tiered Discounts

Estate of Keller (2009)

- Discounts to FLP Asset Values
  - Intent
    - Creation of the FLP was complete based on widow's clear intent to create and fund FLP, even though she failed to completely fund it before her death
  - Discount entitlement
    - Texas case law supports: "intent determines property ownership"
    - 47.5% discount allowed after finding widow's intent effectively transferred the bonds and capitalized the GP account
  - Interest deduction for necessary administrative expenses

Estate of Petter (2011)

- Dollar formula clause and Reallocation clause
  - Together they provided a transfer of a specific dollar amount, with the remainder assigned to specific charities. They also provided that if the value of the units exceeded the specific dollar amount, then the excess should also be transferred to the charities

- Dollar formula clause found *not* to contain condition precedent; therefore, it was valid.

Estate of Wandry (2012)

- Charity is not required, therefore, donees can be family members
- Donor can not "take property back" via the defined value clause (*Proctor*)
  - Not valid if Donor retains the right to *defeat a completed transfer* of property if the transfer is in excess of the annual gift tax exclusion
  - Valid if Donor retains the right to *limit the value* of a completed transfer (*Petter*, *Christiansen*)

Estate of Wandry (2012)

- Defined Value Clause:
  - Intent
    - "Consistent intent and actions" prove whether taxpayers intended to give specific dollar amounts; distinguishable from *Knight*
  - *Proctor*
    - **savings clause** not allowed as it allows donor to "take gifted property back"
  - *Petter*
    - **formula value clause** allowed as it "merely transfers a fixed set of rights with uncertain value"
    - Four part test- "blueprint" to determine if a defined value clause is valid

Tiered Discount Valuations

Should you apply DLOM and DLOC to the underlying business interest as well as the FLP interest?

- Tax court is split based on size of interests held
    1. If *minority* interest in an entity which holds a *minority* interest in another entity, then layer discounts
    2. If lower level interest constitutes a significant portion of the parent entity's assets, or is the 'principal operating subsidiary', then do *not* layer discounts

Estate of Elkins (2014)

- Fractional-Ownership Discount
  - Jointly owned non-business, tangible, personal property
- Fair Market Value test
  - Hypothetical willing buyer would demand significant fractional-ownership discount due to
    - Financial strength and sophistication of co-owners
    - Legal restraints on alienation and partition
    - Co-owners' determination to never sell their interests

Estate of Gallagher (2011)

- Subsequent information may be considered and relied upon where the date of valuation aligns closely to said data.
  - Ex: using second quarter data for a DOV of June 30th, even though information was not released to public before or on June 30th.
    - "Most accurate depiction of market conditions."

Estate of Gallagher (2011)

- Market approach
  - One comparable company is not enough to rely on; must have population to sample from
- Valuation reports must thoroughly explain rationale for making decisions and assumptions in a valuation
  - Analysts should rely on most up-to-date information
  - Vague or unsupported discounts and adjustments will be rejected

How do we value personal goodwill?

Personal goodwill - "the value of earnings or cash flow directly attributable to the individual's characteristics or attributes."

- Ie: repeat business or new consumers seeking out the individual over the business
  - Not considered separable or readily transferable from the individual

Enterprise goodwill – intangible economic characteristics that are attributed to the business entity.

- Ie: company name, reputation of the company, branding, location, facility, phone number, customer lists, trained workforce, etc.
  - Considered separable and transferable from the individual

Key Factors of Personal Goodwill

- Because sales/profits are typically dependent on personal relationships with customers, a hypothetical buyer would want to ensure that the owner/key personnel enter in to a non-compete agreement, so that once the purchase takes place, those individuals holding personal goodwill do not immediately take away clients or potential clients from the business

- They may also decide to enter into an employment agreement

Other Factors to Consider

- Reputation
- Skills & Knowledge
- Relationships
- Expertise
- Experience
- Personality
- Earnings Power/Capacity

MUM

Multi-Attribute Utility Model

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Allocation of Blue Sky Value

Personal goodwill vs. Enterprise goodwill

- Precedent:
  - In Re Marriage of Alexander, Appellate Court of Illinois (5ht District) No. 5-05-019, September 2006.
  - Lieberman v. Lieberman, Case No. FD-2008-956 (Tulsa, Okla.).

Personal Goodwill Attributes	Importance Utility	Existence Utility	Multiplicative Utility	Percent
Ability, Skill and Judgment	15	3	45	25.4%
Work Habits	3	3	9	5.1%
Age and Health	1	2	2	1.1%
Personal Staff	1	1	1	.06%
Personal Reputation	5	4	20	11.3%
Personalized Name	3	4	12	6.8%
Marketing and Branding	1	2	2	1.1%
In-bound Personal Referrals	5	4	20	11.3%
Closeness of Contact	5	2	10	5.6%
Important Personal Nature	5	3	15	8.5%
Total Personal Utilities	44	28		
Total Multiplicative (PGA) Utility			**136**	**76.8%**
Enterprise Goodwill Attributes	**Importance Utility**	**Existence Utility**	**Multiplicative Utility**	**Percent**
Enterprise Staff	3	1	3	1.7%
Business Reputation	3	0	0	0.0%
Business Name	5	0	0	0.0%
Marketing and Branding	3	1	3	1.7%
Business Location	3	1	3	1.7%
Multiple Locations	3	1	3	1.7%
Systems and Organization	3	1	3	1.7%
Marketing and Branding	3	1	3	1.7%
In-bound Referrals	3	1	3	1.7%
Repeating Revenue Stream	5	4	20	11.3%
Total Enterprise Utilities	36	11		
Total Multiplicative (EGA) Utility			**41**	**23.2%**
Total Multiplicative Utility (TMU)			**177**	**100.0%**

With v. Without Test

- Valuation done under the assumption that the key person would be retained with the entity going forward
- Then value the same entity without said key person

  – The difference in value equals key person’s personal goodwill

Martin Ice Cream (1998)

- Majority shareholder worked for corporation, but never had an employment contract or non compete agreement.
- Therefore, shareholder's oral agreements and relationships with vendors were not owned by the corporation. He was the "sole owner of the goodwill".

Estate of Adell (2014)

- Personal Goodwill
  - Possibility to transfer one's personal goodwill *rights* over to an entity by agreement
  - Lack of non-compete agreement effectively increased personal goodwill, thereby reducing value of the company

Bross Trucking, Inc. (2014)

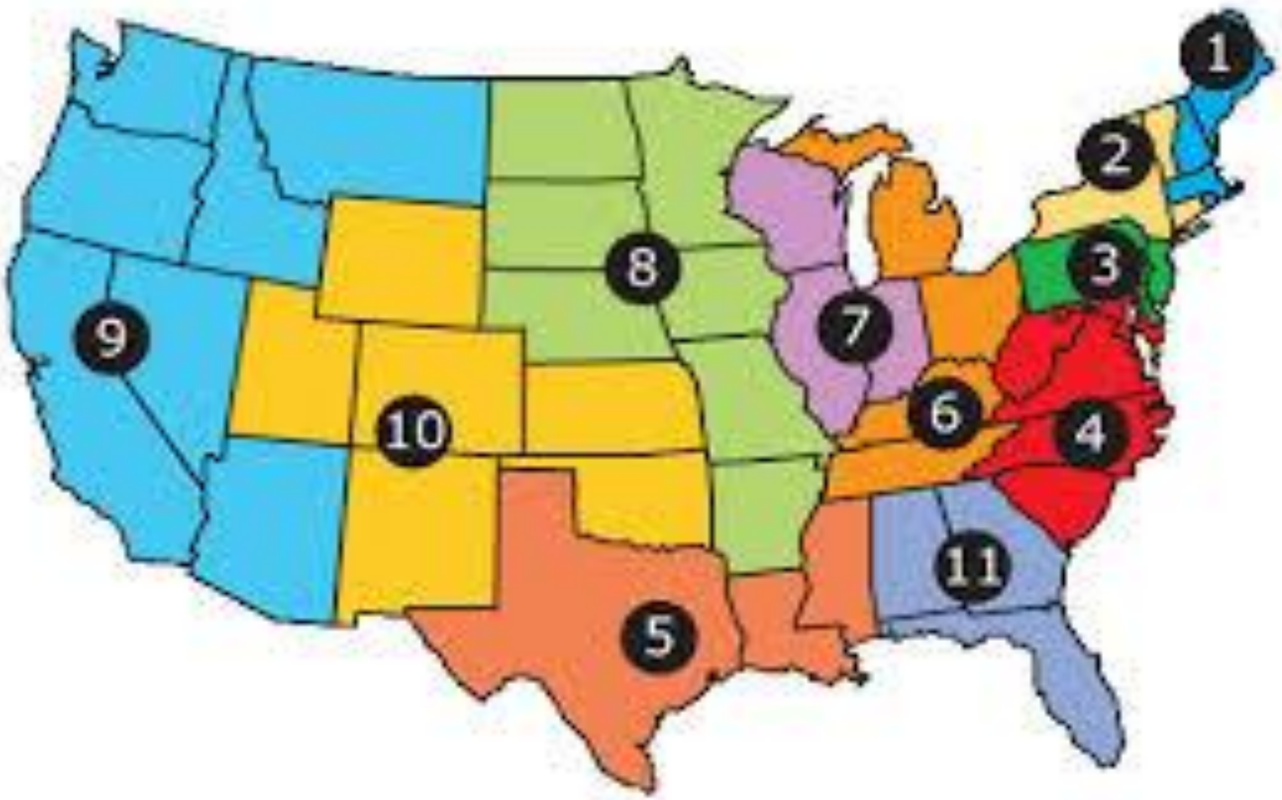
- Corporate goodwill at issue:
  - "a business can only distribute corporate assets and cannot distribute assets that it does not own."
  1. Reputation of old entity was "the antithesis of goodwill"
  2. Employees hired from old entity were determined to be hired on merit rather than transferred to new entity
  3. No organized transfer of customers made from old to new entity

Bross Trucking, Inc. (2014)

- Personal goodwill at issue:
  - "taxpayer did not transfer his personal goodwill to Bross Trucking"
    - No employment contract
    - No right to his future services
    - No non-compete agreement
    - No expectation to benefit from his personal goodwill once he left the business

Therefore, no goodwill, corporate or personal, was transferred to the sons when the new entity was created.

Oklahoma is in the 10th District of the U.S. Circuit Courts



Rules of Thumb

- Sanity check
  - Within a reasonable range?

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