Of Discounts, Taxes, and Subsequent Events: Three Hot Topics in Valuation

Some of the liveliest debates in business valuation are currently taking place around three topics: 1) when to include subsequent events in a valuation report; 2) whether discounts for lack of marketability apply to a controlling ownership interest; and 3) how to calculate deductions for built-in capital gains taxes. While discounts are a perennial"hot" topic, the other two have risen from recent events in the legal and appraisal communities.

Subsequent events

Earlier this year, the AICPA adopted its *Statement on Standards for Valuation Services* (SSVS 1). Among the many important provisions, the new standards clearly require valuation specialists to account for events that occur subsequent to the valuation date only when these events are "knowable or foreseeable." Yet some analysts are uneasy about omitting a discussion of subsequent events from their valuation reports, particularly when a judge or jury—or even a client—will want to hear about them.

Many analysts resolve the problem of subsequent events by convincing the court (through their attorneys) to update the valuation report. Many times, the subsequent events won't materially impact the original conclusions, and analysts are thus able to account for them without substantially altering the bottom line.

But consider the sub-prime lending crisis, which began as early as the summer of 2007—although the extent of the damage wasn't felt in the banking and other industries for several months. When did the credit crisis (and its impact) become knowable and foreseeable? The answer may lie in evaluating what the economic experts and financial indicators were saying as of the valuation date. If this date falls in 2007, for example, when perhaps a few economic forecasters were predicting a downturn—but none as dire as the market declines that eventually took place—then the valuation would most likely omit the impact of these subsequent events.

That's not always what a client or attorney wants to hear. In these difficult cases, it becomes even more important for the valuation specialist to educate the court and the client on the timing of market events and financial inputs. In fact, many believe that it's the best "teacher" who will also make the best case for the trier-of-fact.

Discounts for controlling interests?

Is there a valid, conceptual basis for applying a discount for lack of marketability (DLOM) to a controlling interest of a private (closely held) company?

Probably not, as by definition, a controlling owner can determine the timing and terms of sale. But public markets are not entirely liquid, so many analysts believe that some transactional discount is appropriate, no matter what it's called. (Some use the term "controlling non-marketable interest.") Ultimately, the discount will turn on the facts of the case, as well as the analyst's professional judgment.

Built-in gains

In *Estate of Jelke v. Commissioner* (2007), the Eleventh Circuit Court of Appeals reversed an earlier Tax Court ruling that applied a present value approach to potential future capital gains taxes. The current "bright line" rule, in both the Eleventh and Fifth Circuits, is to apply a dollar-for-dollar reduction for the entire unrealized capital gains tax, even if the business has no immediate plans to liquidate.

At the same time, many valuation analysts still prefer to apply the present value of the anticipated future tax. It's more uncertain, but unless a sale of the business is imminent, there may be a stronger argument for measuring the estimated tax, recorded as a current liability. On the other hand, if there are several prospective buyers as of the valuation date, a better case can be made for deducting built-in gains taxes without calculating the present value of a hypothetical, future sale.

Clearly, *Jelke* recognized that the taxes on the sale of these business assets will eventually accrue; the only question is when and how much. Analysts and their attorneys should consider all relevant factors—and applicable law—when establishing the magnitude of imbedded capital gains.

Q&A

Question:
What creates some of the most difficult issues when transferring the ownership of a business?

Answer:
Your books and records need to be up to date! Whether you are a "mom and pop" business or a middle-market business, buyers buy what buyers can see. If you cannot prove your earnings, then buyers do not want to pay any goodwill for it – particularly in this economic environment. Too many discretionary expenses that the IRS might question make Buyers question too! To paraphrase: Give the IRS what is the IRS's and sell to the Buyer what will actually be the Buyer's.
Do not be penny wise and pound foolish!

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Capital Endeavors, Inc.
P.O. Box 895, 232 Crogan Street, Lawrenceville, GA 30046
Web: www.capitalendeavors.com Email: davidstill@capitalendeavors.com
PHONE: 770-962-8399 FAX: 770-962-8640