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BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

Contacts:

Keith H. Meyers, CPA, ABV, CFF
Shareholder
503.221.7579
kmeyers@perkinsaccounting.com

Peter Kwong, CPA, ABV, CFF
Shareholder
503.221.7541
pkwong@perkinsaccounting.com

Lisa J. Goecke, CPA, ABV, CFF
Shareholder
503.221.7510
lgoecke@perkinsaccounting.com

Paris Powell, CPA, ABV, CFF
Business Valuation Senior Manager
503.221.7564
ppowell@perkinsaccounting.com

Shareholder/Member Agreement's Influence on Value: *Should We Be Bound by Them?*

Our office has recently been involved in several valuation cases where shareholder/member agreements between an owner-spouse and the company have been a central issue in arriving at a value of the owner's equity interest. They are divorce cases in the Commonwealth of Massachusetts, where the standard of value in a matrimonial law context is "equitable value" (sometimes referred to as "fair value.")[1] Equitable value, as many of you may know, is the result of the *Bernier* case, which modified the fair market value standard as follows:

> As a preliminary matter, where valuation of assets occurs in the context of divorce, and where one of the parties will maintain, and the other be entirely divested of, ownership of a marital asset after divorce, the judge must take particular care to treat the parties not as arm's-length hypothetical buyers and sellers in a theoretical open market but as fiduciaries entitled to equitable distribution of their marital assets.[2]

These cases involved business valuations of non-control equity interest positions in investment management firms. Although shareholder/member agreements between an owner and the company they work for is not unique to any one industry, it is our experience that when valuing a non-control position in a money management firm the appraiser should expect to see such an agreement in force and will have to consider the valuation implications in the context of the requisite standard of value.

The requirement to consider such governance is discussed in the standards promulgated by our valuation societies. Several important examples are discussed below:

- USPAP requires an appraiser to identify characteristics of the subject interest including all buy-sell and option agreements, investment letter stock restrictions, restrictive corporate charter or partnership clauses, and similar features or factors that may have an influence on value.[3]

- SSVS No.1 indicates a valuation analyst should obtain, where applicable and available, ownership information regarding the subject interest that includes shareholder agreements, partnership agreements, operating agreements …. or other contractual obligations or restrictions affecting the owners and the subject interest.[4]

- BVS-VI of the ASA standards states that in reaching a conclusion of value the appraiser should separately consider the effect of relevant contractual and/or legal restrictions.[5]

Revenue Ruling 59-60 also requires that restrictive agreements be considered.[6]

The above standards suggest that an appraiser might simply opine on the value of a subject interest based on the provisions contained in a shareholder/member agreement in force between the owner and the company. Agreements of this nature often provide for either a fixed amount or a formula by which to determine a purchase price to redeem out an owner.

But is it really that simple? Or, more importantly, does it produce a credible result within the context of the requisite standard of value? Do these provisions actually come close to value indications resulting from conceptual approaches to valuation? For example, is the value close to that derived from a discounted cash flow method that has thoroughly analyzed the company's expected future cash flows? Does it align with a value based on pricing multiples of publicly traded companies? If not, should the appraiser accept the fixed/formula-driven computation and justify it based on the equity interest being a non-control position? What is an appraiser to do?

The answer at our firm has been to consider the agreement in the context of the standard of value. In *Bernier* the court looked to the fiduciary relationship. In Massachusetts, a fiduciary relationship has been described as "of utmost good faith and loyalty."[7]

As a means of background, *Bernier,* in part, concluded there is no marketability discount if there is no intent to sell and no lack of control (minority interest) if there are also no extraordinary circumstances.[8] These are modifications to the fair market value standard, and in many instances result in a higher value indication than fair market value. They do not, however, alter the underpinnings of fair market value and the intellectual construct that provides the framework essential to arriving at an economically sensible value.

Most of us are aware of tax court cases that have pondered the conceptual framework of fair market value.[9] These courts considered important premises regarding a transfer, including, but not limited to:

- It is between a hypothetical buyer and hypothetical seller
- It is at arms-length
- There is no compulsion to transact

In *Knott*, the court said, in part, that the willing buyer/willing seller test was objective and that the transfer must be analyzed from the point of view of the hypothetical seller trying to *maximize* (emphasis added) his profit. It was also not lost on the court that there is no compulsion to transact.[10]

In our divorce cases the non-control owner asserted that the only value appropriate to use in determining the value of the marital estate was that determined by following the purchase price formula provided for in the agreement between them and their company.

In one case the formula was based on recent historical performance which we noted was particularly poor since it included the recent severe recession. The resulting value produced using the formula was quite low. Discussions with management indicated the company had turned the corner and that revenue growth and improved cash flows were expected. Indications of value derived from the discounted cash flow and guideline public company methods corroborated these future expectancies and resulted in much higher values.

In another case the agreement called for a fixed threshold value to be exceeded before any value was assigned to the owner's purchase price, in the event the owner left the company.[11] As the company grows this threshold remains a fixed and smaller percentage of the company's value (assuming the company's value grows). The owner took the position the stated threshold amount should be subtracted from today's value. His business appraiser agreed, substantially reducing the owner's value by several million dollars. We took issue with this application noting the owner was very young and most likely should be expected to work for many more years.[12] We pointed out that the effect of a fixed-dollar threshold diminished each year the owner remained;[13] but the owner would continue to collect his proportionate share of the annual (and growing) distributions.[14]

The essential question, in our minds, was whether it was reasonable to expect that an owner would self-impose a significant financial penalty on himself when he is under no compulsion to do so? Is it appropriate to conclude such a financial penalty applies simply because an owner states he wants to quit (at some point) and start a new career in a different profession, all the while being entitled to his proportionate share of the company's growing annual distributions? The concept of equitable value assumes both parties in a divorce situation are acting as fiduciaries with respect to the assets in question. In particular, it implies that a business owner would not intentionally impair the asset with which he or she has been entrusted (usually a share in a closely held business). In these cases with which we are involved, it is not reasonable to expect the owners to act to *maximize* the penalty to value.

Although there are times when shareholder/member agreements should be given appropriate weight in determining value, there are also times when they should not.

In *Pabst Brewing*, Judge Laro indicated that reasonable, realistic, and objective possible situations in the near future should be given the greatest weight in assessing the value of an asset; whereas, those elements that depend on events or occurrences, while possible but not reasonably probable, should be excluded from this consideration.[15]

USPAP discusses whether the quality of appraiser's work is complete, accurate, relevant, appropriate and reasonable. When considering shareholder/member agreements and the emphasis, if any, that should be afforded to them, it is wise to consider these factors, otherwise it could result in an opinion of value that is not credible.

By Stephen J. Bravo, ASA, CBA, CPA/ABV/PFS, CFP, MST
Apogee Business Valuations, Inc., Framingham, MA

The author thanks Michael Mattson for his insights and assistance with this article.

1 Not to be confused with "fair value" used for financial reporting purposes.

2 *Judith E. Bernier vs. Stephen A. Bernier*, 449 Mass.774, 785 (2007).

3 Standard Rule 9-2(e)(iii), *USPAP 2012-2013 Edition*, The Appraisal Foundation.

4 *Statement on Standards for Valuation Services No.1*, AICPA.

5 American Society of Appraisers, ASA Business Valuation Standards, BVS-VI (Reaching a Conclusion of Value).

6 Revenue Ruling 59-60 mentions such an agreement is a factor to be considered, with other relevant factors, in determining fair market value. The ruling further indicates it is always necessary to consider the relationship of the parties.

7 *Donahue v. Rodd Electrotype Co. of New England, Inc.* (Mass. 1975)

8 Extraordinary circumstances have yet to be explicitly defined by the Courts.

9 Several notable cases include *Bright, Andrews, Newhouse* and *Watts*, to name a few.

10 *Henry J. Knott*, TC Memo 1988-120, Code Sec(s) 2512.

11 The threshold did not apply if the company were sold or if the owner retired for good reasons (defined in the agreement). It only applied if the owner voluntarily retired without good reason at the valuation date.

12 In *Adams,* an investment manager was considered to have 14 years of work remaining (to age 62). His expected cash flow during this 14-year period were converted to present value using a discounted cash flow methodology. Mr. Adams was also expected to receive 10 years of retirement income at the conclusion of his work life. These expected cash flows were also converted to present value. (*Adams v. Adams*, 459 Massachusetts. 380-381 (2011)).

13 The reduction in the value of the company is actually the present value of the threshold calculated in the year in which the threshold might be incurred. For example, if the threshold is $5 million and the cost of capital is 20% and the threshold is expected to be triggered 10 years from now, then the reduction in the value of the company would be about $808 thousand ($5,000,000/((1+0.20)^10)); which is nowhere near $5 million. This situation is complicated further in that not all types of departures from the company trigger this threshold calculation. In fact, most do not; thereby, reducing this $808 thousand even further.

14 The company is very profitable and long-term growth is expected and is included in capitalizing the terminal year cash flows using the income approach.

15 Paraphrased from *The Lawyer's Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony, (*American Bar Association), 2nd ed., (2013), Shannon Pratt and Alina Niculita, Chapter 4 and footnote 6, which cites *Pabst Brewing Co. v. Commissioner*, T.C. Memo, 1996-506 (1996).

FEATURED CASE

ESTATE OF HELEN P. RICHMOND V. COMMISSIONER

CITATION:
ESTATE OF HELEN P. RICHMOND, DECEASED, AMANDA ZERBEY, EXECUTRIX, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

T.C. Memo. 2014-26, Docket No. 21448-09, Judge: Hon. David Gustafson, Filed: February 11, 2014

OVERVIEW

To determine the value of the decedent's 23.44% interest in Pearson Holding Co. ("PHC") at the time of death, the court resolved the following disputes:

- Whether the capitalization-of-dividends method or net asset value ("NAV") method should be used, and
- The appropriate discounts applicable to the NAV method.

THE FACTS

PHC is a family-owned investment holding company that was incorporated in Delaware in January 1928. The company's philosophy is to maximize dividend income. As a holding company subject to tax on undistributed income, PHC has a strong incentive to pay out most of the dividend income, with the objective to provide a steady stream of income to the descendants of Frederick Pearson while minimizing taxes and preserving capital. The court also found it noteworthy that PHC's dividends grew slightly more than 5% per year from 1970 through 2005.

As of December 2005, Helen P. Richmond owned 548 shares in PHC, a 23.44% minority interest. The decedent had no right to "put" her stock to the company, and the company could not "call" her stock.

Historically, the capitalization of dividends approach was used for nine transactions involving the sale or redemption of PHC stock between 1971 and 1993, and once more in 1999 when a shareholder died. For the 1999 estate, the Federal estate tax return relied upon the capitalization of dividends method.

Ultimately, the IRS issued a statutory notice of deficiency with a valuation adjustment from $3,149,767 to $9,223,658, which increased the estate tax liability by $2,854,729. Additionally, a 40% gross valuation misstatement penalty of $1,141,892 was asserted pursuant to section 6662(h). No other adjustments were made to the gross estate.

CONCLUSION

Absent direction from the Third Circuit (where the current dispute might be appealed) and in spite of contrary rulings in the Fifth and Eleventh Circuit Courts (which ruled in favor of 100% BICG discounts), the court decided that the most reasonable discount for PHC's BICG tax liability was the present value of its future liability. Since the Commissioner's discount fell with the court's range of values, it was considered reasonable.

To determine the discount for lack of control, the court used the Commissioner expert's data set of 59 funds and removed the outliers to determine a mean discount of 7.75%.

Relying upon the range of marketability discounts that the parties agreed was between 26.4% and 35.6%, a discount of 32.1% was selected by the court.

Concluding that the value of the decedent's interest was $6,503,804 compared to the $3,149,767 reported on the estate tax return, the asserted deficiency summary was upheld. In addition, the court ruled the estate failed to demonstrate it acted with reasonable cause. Therefore, the court upheld the accuracy related penalty under section 6662(a), (b)(5), and (g), as well.

TAKEAWAY

The 20% accuracy-related penalty under section 6662(a), (b)(5), and (g) could have been avoided if the estate demonstrated that it acted with reasonable cause and in good faith with respect to the under valuation. However, using an unsigned draft report prepared by its accountant as its basis for value failed to meet the burden of proof for exclusion from the penalty because the accountant did not have any appraisal certifications, was not used as an expert at trial, and the taxpayer did not demonstrate the accountant was qualified as a valuation expert.

By Chris D. Treharne, ASA, MCBA, MAFF
Gibraltar Business Appraisals, Inc., Longmont, CO