BUILDING VALUE

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

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Top Five Issues When Valuing a Small Business for Divorce

Valuing a business for divorce has a variety of complexities not present for other valuation purposes. In this article I'm going to discuss what I believe are five of the most important issues.

1. STANDARD OF VALUE

In all tax business valuations and many other "non-divorce" valuations, the standard of value utilized is fair market value which is defined in the *International Business Valuation Glossary* as "the price at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

Many analysts believe that fair market value is based on an actual transaction. In a divorce, generally there is not an impending sale or transaction of a business interest. Even when there is a transaction it generally is not similar to that of a hypothetical willing buyer or hypothetical willing seller because the buyer and seller are known and there are often (significant) emotions involved in a divorce-related transaction.

Recognizing the difference between the fair market value situation and the divorce situation, many states have decided by statute or precedent to use a different standard of value for divorce cases. In New Jersey, for example, we follow *Brown v. Brown*, 348 N.J.Super. 466 (App. Div. 2002) where the appropriate standard of value is fair value which is defined as fair market value without discounts, except in "extraordinary circumstances." The divorce scenario is related to that of a distressed/oppressed shareholder (where fair value is utilized) where it would be inequitable to the non-propertied spouse to discount the ownership interest being valued.

The *International Business Valuation Glossary* defines investment value as "the value to a particular investor based on individual investment requirements or expectations." This standard reflects the value to a specific buyer given what he or she is looking to get out of the deal. Some states rely on this standard of value, believing it is more relevant in a divorce situation. There are differences among the states as to what the appropriate standard of value is, so you need to know what is acceptable within

your state. Your opinion could be thrown out for not using the appropriate standard of value.

2. USE OF THE MARKET APPROACH

The guideline public company method is usually disallowed in small business divorce cases because

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M&A Deals - Stock vs. Asset Sales: What Every Valuator Needs to Know

Whether an M&A deal is structured as a sale of stock versus sale of assets can have tremendous impact on both the buyer and seller. It is critical that the analyst understand both the legal and income tax implications of each alternative.

Generally, the greatest majority of small business sales are asset sales. As the size of the business increases, the potential for a stock sale or some form of tax-free reorganization increases.

This article focuses solely on the legal and tax implications of stock versus asset sales. It is written for valuators who have limited experience with and knowledge about the tax implications of M&A deals. As a result, the concepts are presented as an introduction to this area. Of course, in a typical deal, there are complexities which arise. The author recommends that the reader consult a qualified tax adviser for more in-depth guidance in real world applications. Hopefully, this article will provide the reader with sufficient background to be conversant on the issue of stock versus asset sales.

The most critical differences between stock and asset sales usually occur in transactions where the seller is a C corporation. The examples below demonstrate the tax results for a C corporation seller under either an asset sale or a stock sale structure.

EXAMPLE 1: C CORPORATION STOCK SALE

Buyer B is paying $1 million for all of the stock of XYZ, a C corporation. XYZ has $100,000 of cash and goodwill worth $900,000 with a $0 tax basis. Seller S (XYZ's shareholder) has $0 basis in her XYZ stock.

Result to Buyer:

- B has basis in his newly acquired stock of $1 million.
- However, since B purchased stock, he cannot deduct anything for the goodwill worth $900,000.
- B might liquidate XYZ after the purchase in order to begin amortizing the $900,000 of goodwill. However, if B liquidates XYZ after the transaction, XYZ will pay over $300,000 in taxes due to the value of the goodwill in excess of basis. This is the result because a corporate liquidation results in a "deemed sale" of all assets at fair market value for income tax purposes. A $900,000 gain taxed at a C corporation rate of 35 percent is in excess of $300,000. State tax, if applicable, would add to this.
- At the shareholder level, B will have a capital loss on the liquidation of $300,000. B receives $700,000 in liquidation (all the assets of XYZ less the XYZ taxes paid). Since B has a cost basis in XYZ stock of $1 million, the capital loss results.
- This capital loss may be deductible only $3,000 per year (for a very long time!) unless B has other capital gains.
- If XYZ has any undisclosed liabilities (product liabilities, contractual obligations, employee discriminations lawsuits, prior years' tax issues, etc.), those obligations go with the stock. Thus, XYZ would be liable for those liabilities after B has purchased the stock, even though B was unaware of them.

Results to Seller:

- This is an ideal situation for S, the shareholder of XYZ. She has been paid $1 million for her stock.
- S will pay capital gains tax on $1 million, or $150,000 (assuming a 15% capital gains tax rate).
- S is not responsible for XYZ's $300,000 of taxes upon its liquidation.
- S is not liable for any of XYZ's undisclosed or contingent liabilities.

As stated earlier, the greatest majority of small business sales are transacted as asset sales. It should be readily apparent from the above example why this is the case. A knowledgeable, informed buyer is going to be very reluctant to accept all the disadvantages inherent in a stock sale. Where I have seen stock sales occur, there often is a substantial discount in price to reflect all the disadvantages discussed in the above example.

EXAMPLE 2: C CORPORATION ASSET SALE

Assume the same facts as in Example 1 except that B purchases all the assets of XYZ (the $100,000 of cash and $900,000 of goodwill).

Result to Buyer:

- B has basis in goodwill of $900,000. This can be amortized over 15 years under IRC Section 197. This gives B an annual deduction of $60,000 which was not available in the stock purchase.
- Since B is purchasing assets, B does not acquire XYZ stock and therefore is not liable for any income taxes upon the liquidation of XYZ.
- With proper legal and tax guidance, B should no longer be concerned about any XYZ contingent or undisclosed liabilities (product liabilities, contractual obligations, employee discriminations lawsuits, prior years' tax issues, etc.).
- Since those obligations follow the stock, they remain S' concerns.

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FEATURED CASE

ESTATE OF RICHARD V. COMMISSIONER

CITATION:

ESTATE OF ALFRED J. RICHARD, DECEASED, GARY H. RICHARD AND PETER C. RICHARD, CO-EXECUTORS, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent

T.C. Memo. 2012-173, Docket No. 9876-09, Judge: Joseph Robert Goeke, Filing date June 20, 2012

VALUATION FACTS – FROM THE COURT

In an unusual case, a wife owning preferred shares in a closely-held company predeceased her husband. Almost six years after her husband's death, his personal representatives discovered the wife's will 13 years after her death. At issue for the court is whether the wife's shares are includable in the husband's estate.

The estate valued the Decedent's preferred stock at its par value, $1,000 per share. In contrast, the IRS valued the preferred shares at $192,166.22 per share. While the valuation dispute will be settled subsequent to this case, readers can nonetheless benefit by realizing that the fair market value of closely-held preferred shares likely will not be par value. Many factors (including contemporaneous market rates for preferred stock, cumulative versus noncumulative dividends, call features, convertibility, etc.) may affect fair market value in relation to par value.

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Results to Seller:

- Seller S has some challenges. The $1 million paid by B for XYZ's assets are paid to XYZ, not S.
- XYZ is taxed on the sale of the assets resulting in over $300,000 of taxes.
- If S chooses to liquidate XYZ, she will pay capital gains tax on $700,000 (the net assets remaining in XYZ after payment of taxes), or $100,000 (assuming a 15% capital gains tax rate).
- If S decides not to liquidate XYZ in order to avoid the $100,000 of taxes on liquidation, XYZ may be subject to the Personal Holding Company tax on future income, depending upon the nature of its future income.
- In total, S and XYZ combined will pay $400,000 in taxes on the sale and liquidation, or about 40 percent in taxes.
- State taxes may cause this 40 percent to be closer to 50 percent.
- XYZ continues to be liable for any of its undisclosed or contingent liabilities.

ENTITY: WHAT IF THE SELLER IS AN S CORPORATION?

If the selling entity is an S corporation instead of a C corporation, a different set of issues arise. The differences to be considered include:

- Has the seller been an S corporation since inception? If so, there normally will be no tax at the corporate level for an asset sale.
- If the corporation previously was a C corporation and elected S within the last 10 years, there may be a corporate level tax on an asset sale (the built-in gains tax).

Whether the seller is a C corporation or an S corporation, a significant issue for the buyer is what undisclosed liabilities including product liabilities and contractual obligations the buyer may be assuming in a stock purchase. This is one of the biggest reasons buyers almost universally prefer to purchase assets rather than stock. One way this is at times addressed is through a hold harmless provision in the contract so that the seller agrees to indemnify the buyer in the event of buyer's ultimate liability for undisclosed liabilities. However, to collect on this, the buyer may have to sue the seller and the seller may or may not have sufficient assets for the buyer to collect at the point in time of the successful lawsuit. It is also important to remember the potential for IRS examinations of past years' tax returns, potential lawsuit by ex-employees, etc. in the event of a stock purchase.

Hopefully, this will help the reader understand why the stock sale versus asset sale decision is often such an important one.

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of the lack of truly comparable companies and the size differentials. In larger cases where the method may be appropriate, practitioners need to make sure they account for the different attributes and levels of risk between the comparable public companies and the subject company.

Another commonly used method under the market approach is the comparable transactions method. Unfortunately, the most commonly used databases provide only one year of data. Details are extremely limited in most cases so the data fails to answer the questions: What about previous years? If the seller knew he was going to sell, wouldn't he have tried to paint the best positive picture? In addition, the data contains no normalizing adjustments. How many family members are over- or underpaid and included in the data? What was the motivation of the seller? Are the economy and industry the same in that geographic area as where the subject business is? These questions don't even address the misapplication of the method that occurs by many practitioners.

3. USE OF INCOME APPROACHES

In some states, for example, California and Missouri, discounted future earnings or cash flow methods are prohibited in a divorce because it is deemed to be too speculative and the ex-spouse is not entitled to receive any benefit from post-marital efforts. In other jurisdictions, such as Colorado, there is ongoing debate about the topic.

Although there are more variables in the discounted earnings method, to be attacked by the other side, the capitalized earnings or cash flow method is the same as the discounted earnings method with the use of a constant growth rate. Are we are not educating the lawyers and judges properly if they can't understand this? In the current economic state, the discounted earnings method may be more representative of future operations and yet some states completely throw it out without consideration.

On the other hand, when the weatherman can't predict the weather accurately for three days from now, how are we going to predict future income for the next three, five, or seven years … particularly if the business has had a rocky past or is in a growth stage? We can use industry projections. You will see that different industry experts have different projections, just like the weather people on ABC, CBS, NBC, and the Weather Channel. Depending on the business, it may be easy to project the future, if there are contracts in place, for example. Otherwise isn't it just a SWAG? Even if it is a SWAG, the appraiser needs to support the assumptions used as much as they can with empirical data. Be reasonable. It is your opinion and your reputation on the line.

Here is another income approach issue: *What do you do when there is unreported income?* A large number of practitioners would say add it in and tax effect it. That is reasonable. What if you are told that the unreported income is going to continue? Do you still tax effect it? If you do, you are decreasing the income available for support by a meaningless amount that will benefit the business owning individual.

4. REASONABLE COMPENSATION

The application of the various market approach methods and income approach methods can be dramatically affected by adjustments for reasonable compensation. When it comes to divorce, we have to remember that perhaps we are dealing with more than just the value of the business. We also need to address perquisites, discretionary expenses, personal expenses disguised as business expenses, the many duties of an individual, and also family members or "friends" being paid out of the business but not performing the appropriate level of duties for their compensation.

The "double dip" argument is a significant issue in family law matters. If Husband's reasonable compensation is $300K, the value of the business is $2M and alimony is based on $300K per year. If his reasonable compensation is adjusted to $400K, the value of the business is now worth $1.5M and alimony is based on $400K. The attorneys will look at where their client gets the most bang for their buck and will likely end up negotiating with the non-propertied spouse's percentages (in this example) in order to settle the case.

5. APPLICATION OF DISCOUNTS FOR LACK OF CONTROL AND LACK OF MARKETABILITY

In one of the previous sections, I talked about SWAGs. Nowhere is this more apparent than in the application of discounts. There are numerous court cases, primarily dealing with estate and gift tax cases, studies, and databases available to support the selection of discounts, however, rarely are two cases exactly alike. Many practitioners would have to admit, if they thought about it honestly, that they were pulling their numbers out of the air based on what is generally accepted in the (family law) community.

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