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BUILDING VALUE

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

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Synergy and Fair Market Value: Are they mutually exclusive? *BTR Dunlop* says 'no'

We were recently engaged to value an electric supply business that had received a letter of intent (LOI) from an unrelated party to purchase the stock of the company for a very large purchase price. The valuation was for gifting purposes, so the standard of value was fair market value.

While the LOI does not carry the weight of an actual sale, it is a foreseeable event that should be given consideration on the valuation date.

As part of our analysis we searched for cases, rulings, regulations, etc. that discussed synergies in the context of fair market value. In other words, we wanted to know if fair market value could or should include the synergistic attributes that were mostly likely embedded in this LOI. We found one case:[1] *BTR Dunlop*.[2]

The fair market value standard assumes that the hypothetical buyer will not be a "strategic buyer" who typically pays more than fair market value to acquire control of a business that provides some strategic advantage to that buyer. I believe the fair market value standard assumes that the hypothetical buyer is a "financial buyer" who buys or invests in the company expecting to earn a return on investment appropriate to the risk of the business, excluding any additional strategic value the business might have to a strategic buyer.

Fair market value is defined as the price that a willing buyer would pay a willing seller, both having reasonable knowledge of all relevant facts and neither being under the compulsion to buy or sell.[3]

Courts, in their quest to determine fair market value, have made the following observations:

- The willing buyer and willing seller are hypothetical persons rather than specific individuals or entities and the peculiar characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of an actual seller or buyer.[4]
- The hypothetical willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage.[5]
- The hypothetical sale should not be constructed in a vacuum isolated from actual facts that affect value.[6]

These precedential findings have often been considered to imply that the fair market value standard of value cannot consider synergies that often form the basis for another standard of value – namely investment value – which is defined in the *International Glossary of Business Valuation Terms* as "The value to a particular investor based on individual investment requirements or expectations."

continued on page 2

continued from page 1

Rather fair market value implies valuing a company on a stand-alone basis. It further implies that only facts relevant to the subject company should be analyzed - to incorporate other assumptions or circumstances beyond this violates the bright line premise of the fair market value standard and is therefore inappropriate.

But is this always the case? Should a fair market value appraisal always exclude synergies? Should fair market value explicitly assume assumptions, limiting conditions and circumstances that apply only when valuing a company on a stand-alone basis? Does a stand-alone valuation imply a highest-and-best use (HBU) value?

In *BTR Dunlop* the tax court valued a U.S. holding company's United Kingdom and German subsidiaries that were acquired based on their earning potential, which included, in part, synergies to be achieved as a result of the acquisitions.

Briefly, the case involved Schlegal Corporation (Schlegal), whose primary business was in the production of automotive, building and industrial seals. Schlegal was in need of additional capital to fund its business growth. There were six prospective buyers of Schlegal, one of which was BTR Dunlop. BTR Dunlop had a sealing system business and acknowledged that this prospective acquisition was a synergistic fit.

Upon consummating their successful bid to purchase Schlegal, BTR Dunlop planned to transfer Schlegal's UK and German subsidiaries to another BTR Dunlop entity. These transfers would create a deemed sale thus triggering taxable transactions. Valuations of the UK and German subsidiaries were performed, the transfers were executed, and the gain on each transfer calculated based on the appraisals.

Upon examination, and after reading the valuation reports, the IRS issued a notice of deficiency claiming that the appraised values used to report the taxable transactions were undervalued for both subsidiaries. One of the issues, but not the only issue, was the IRS rejection of a stand-alone valuation theory in favor of a highest-and-best-use (HBU) value for the UK subsidiary (the larger and more valuable of the two subsidiaries).

In defending their tax positions, BTR Dunlop relied upon several appraisal experts (two opined on the value of the UK subsidiary and one opined on the value of the Germany subsidiary). In the case of the UK subsidiary, one appraiser explicitly did not take synergies into consideration. The other appraiser valued the UK subsidiary on a synergistic and stand-alone basis giving each method equal weight.

After considering all of the evidence the tax court conclusions included the following:

- The fair market value of property should reflect the highest and best use to which the property could be put on the valuation date.
- The court was not persuaded that BTR Dunlop adequately considered the potential for synergies in valuing the UK subsidiary.
- The court also disagreed with the commissioner's proposed valuation because too much reliance was placed on the synergistic valuation of the UK subsidiary resulting in an unrealistically high value.
- The court was not persuaded that buyers existed who would be willing to pay the value asserted by value put forth by the commissioner.

The tax court was also concerned that some of the adjustments made by the appraisers were based on hindsight as to matters occurring subsequent to the valuation date, and that not all relevant facts were properly investigated by the appraisers.

The practical question facing us was whether to incorporate any information from the LOI into our fair market value analysis. While the LOI does not represent a completed transaction, it indicates a very strong interest in the subject. Furthermore, there had been a number of acquisitions in the subject's industry suggesting that the level of interest expressed in the LOI for the subject was probably not unusual. The purchase bid from one willing buyer, as given in the LOI, appeared to incorporate expected synergies.

We concluded that because of the fairly high level of acquisitions in the industry, willing buyers and willing sellers would probably be working with prices incorporating some sort of synergies. While we did not rely entirely on the price in the LOI, we gave it some weight in our conclusion of fair market value. We believe our approach is consistent with the finding in the tax court case cited above.

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[1] RIA Checkpoint has an application called the Citator that tracks the history of any litigated case or IRS ruling. It tracks the cases from the lower courts through any appeals including the Supreme Court. It will also show any court case or IRS ruling that was cited within the case being researched. These cited cases are listed indicating whether the case was favorable, unfavorable, or distinguishable from the primary case. Some of the cases listed may not include the issue being researched. Litigated cases can have many issues, and consequently, may have been cited for another issue discussed in the primary case and not the issue being researched. Cases in the Citator may have been cited to establish a precedent, standard or court procedure. For example, a court may cite cases in its opinion section to establish the standards for fair market value or who has the burden of proof and then go on and apply these principles to arrive at their conclusion. Each case in the Citator must be reviewed for its relevance to the issue being researched, if it would apply at all.

[2] *BTR Dunlop Holdings Inc., et al. v. Commissioner*, TC Memo 1999-377.

[3] *United States v. Cartwright*, 411 U.S. 546, 551 (31 AFTR 2d73-1461).

[4] *Estate of Bright*, 658 F.2d 999 CA5.

[5] *Estate of Newhouse v. Commissioner*, supra 218.

[6] *Estate of Andrews v. Commissioner*, supra at 956.

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ADVOCACY VS. OBJECTIVITY

Being a business valuator/expert witness often places the practitioner in the precarious position of deciding whether to be an advocate for their client's position or an objective professional whose job it may be to not necessarily please the client. After many years of practice, it is very difficult for the practitioner to separate his or her role, but it is especially important during litigation engagements. Let's first examine both roles and how they apply to litigation.

The best example of an advocate is your client's attorney. That attorney's job is to do whatever is necessary (legally, of course) to present the client's case in such a light that the client wins the lawsuit and ends up with as large a settlement as possible. The advocate will omit items that do not help the client's cause and take the position that if opposing counsel does not raise an issue, it will be left unsaid.

The business valuation practitioner can assume the role of an advocate when hired to support the attorney and client in the litigation, although this is generally done only when expert testimony is not a possibility.

When testimony is expected to be given, the practitioner must remain objective, even though instinct dictates that he or she should fight for the client's benefit. In this type of situation, the practitioner will actually be a greater benefit to the client for at least two reasons:

1. Although the client may not be happy, the truth may save your client from the emotional and financial costs of a protracted litigation. An extreme position may convince the client that there is a false "pot of gold" at the end of the litigation that may never be realized.

2. The practitioner that serves as an expert witness will lack credibility in the eyes of a judge or jury if the position taken by the practitioner is that of an advocate.

During litigation, there is rarely a client who does not feel the emotional impact of the issue that caused the lawsuit to be filed originally, as well as the impact of the ongoing proceedings. It does not matter if the case involves a divorce, a stockholder breakup (which in many respects is similar to a divorce), damages litigation, or a breach of contract litigation. The client is angry because he or she feels that a wrongful act has been committed, either forcing the client to file a lawsuit or having a lawsuit filed against him or her.

To illustrate the painful effect of an advocate's position, let's look at a business valuation issue in a divorce.

Harry and Sally are going through a divorce. Harry owns a business that he had appraised by an independent appraiser for $1 million. Sally's attorney recommends Joe Appraiser who values Harry's business at $5 million. During the valuation, Joe Appraiser ignores the fact that Harry's largest customer, who accounts for 63 percent of his business, died of a heart attack. Joe Appraiser also determines Harry's reasonable compensation to be $25,000 per year despite industry statistics, and Harry's work habits, which justify a salary of approximately $150,000.

Joe Appraiser meets with the attorney and Sally and convinces Sally that his salary position "could be" (rather than "is") justified and says nothing about the main customer's death. The end result is that Harry and Sally cannot reach a settlement because of the great disparity in the values of Harry's business and they go to trial.

The trial does not take place for almost two years due to the backlog in the court system. During that period, Harry and Sally are bitter over their perception that they were each being cheated out of a fair settlement by the other party.

At the time of trial, both attorneys prepare for trial, meet with their respective expert witnesses and proceed with their case.

The legal and expert fees incurred by Harry and Sally are in excess of $50,000. The judge accepts the value of Harry's business as being $1 million based on the testimony of the independent appraiser.

What did Joe Appraiser's position of advocacy do to Sally? First, she waited for more than two years to be finished with the divorce and go on with her life. During that period, her life was in turmoil, she was dependent on Harry's temporary support and did not know where she would be living after the divorce if the marital house was ordered to be sold. In addition, she became more and more agitated at the thought of Harry trying to "stick it to her" and she became a very bitter person. Let's also not lose sight of the fact that her legal and expert fees were about $30,000. Worst of all, she ended up with the same amount of marital property (less legal and expert fees) as she would have two years ago.

FEATURED CASE

ESTATE OF JAMES A. ELKINS, JR., V. COMMISSIONER

CITATION:

ESTATE OF JAMES A. ELKINS, JR., DECEASED, MARGARET ELISE JOSEPH AND LESLIE KEITH SASSER, INDEPENDENT EXECUTORS, Petitioners V. COMMISSIONER OF INTERNAL REVENUE, Respondent.

140 T.C. NO. 5, DOCKET NO. 16597-10, JUDGE: JAMES S. HALPERN, FILED MARCH 11, 2013

OVERVIEW

In a case of great interest to appraisers of all stripes, James A. Elkins, along with his children, owned fractional interests in 64 pieces of art, some of which were from famous artists. Upon his death in 2006, his estate valued his fractional interests in the art with deep discounts. The IRS challenged the discounts, asserting no discounts were appropriate.

TAKEAWAY

In a complex case, the Tax Court determined that discounts to fair market value for undivided interests in art were permissible. Specifically, "[t]here is no bar, as a matter of law, to an appropriate discount from pro rata fair market value in valuing, for estate tax purposes, decedent's undivided fractional interests in the art."

Experts for both sides testified that markets for undivided interests in art was very limited. Even though empirical data for discounts for lack of marketability (only, not control and marketability) for stock interests in more developed markets suggest greater discounts are appropriate, the court ultimately settled on a ten-percent total discount.

Importantly, the court rejected the IRS claim that discounts should be limited to the difference between the sale price and a seller's proceeds. Instead, it held "fair market value to be the gross amount paid by the buyer to the seller." Said in another way: Fair market value is consideration passed from buyer to seller, which should not be distorted by the seller's net proceeds.

CONCLUSION

The Tax Court determined that undivided interests in artwork are likely subject to discounted values. However, due to non-existent transaction data and limited guidance from the estate's experts, the concluded discounts were much less than initially determined by those experts.

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continued from page 3

In this situation, the appraiser, although good intentioned, hurt the client with a position of advocacy. Granted, this situation sounds extreme, but it happens more often than can be imagined.

Let's also look at what advocacy does for the appraiser. After this matter gets to court, the judge finds Joe Appraiser's position to be that of a "hired gun" and determines that he lacks credibility. The independent appraisal expert remains objective and assists the other side with a victory. Joe Appraiser, or any other expert for that matter, should not believe that attorneys and judges do not talk about experts.

Our experience has been such that word gets around fast about the reputation of an expert. As an expert, the business valuator must demonstrate a particular level of knowledge about the subject matter for which testimony will be given, but the reputation of that expert is critical, particularly where the opposing expert communicates well.

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