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Valuation Report

Business Valuation Trends and Strategies

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Tax Matters

Research Backs Validity of Tax Affecting S Corporations

In their most recent publication, "Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle," valuation authorities Nancy Fannon and Keith Sellers again attempt to move the conversation forward regarding the legitimacy of tax affecting of S corporations.

The ongoing debate about tax affecting now centers on how to derive the cost of capital for S corps. To do so, valuation analysts generally rely on a variety of inputs, many of which are based on C corp data. But because C corps are subject to double taxation, valuation analysts often "tax affect" S corps to create a C corp equivalent and then add a premium for S corp status when estimating fair market value.

While that sounds completely logical to most valuation analysts, the IRS has not acknowledged that S corps should be tax affected. The landmark tax court case on tax affecting, *Gross v. Commissioner*, resulted in a ruling that tax affecting earnings should not be considered to be standard practice.

Market Data Misunderstood

Fannon and Sellers' new guide presents decades of academic research on the impact of taxes on business value. The authors say that their work "demonstrate[s] that historical market returns impound the effects of shareholder taxes, and these returns can be adjusted to estimate a cost of capital appropriate for pass-through entity valuation."

In other words, Fannon and Sellers feel that they have gathered enough empirical evidence to show that tax affecting used in the development of the cost of capital is valid.

They critique existing theories about tax affecting, suggesting that historical market return data from C corps is often misunderstood. For example, they say that "shareholder taxes deducted from cash-flow based models should reflect the fact that public market investors pay a mix of dividend and capital gain taxes … and many [institutional] investors pay no taxes at all. Therefore, the extent of shareholder taxes deducted from the public-market C corporation component of the calculation should be muted."

An Alternative Model

Believing that current models often overstate S corp value, Fannon and Sellers offer a new model. Their model combines information from the academic studies with empirical data from public-market returns, resulting in what they believe is a "proper matching" of the cost of capital derived from the public market to the S corp.

Their formula is quite complicated, but it is based on the idea that the way to remove the effect of embedded shareholder-level taxes is by adjusting the discount rate itself. This

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The Damage Done

The Ins and Outs of Calculating Lost Profits

When a company suffers a financial loss, what exactly is "lost"? This is the question faced by CPAs and valuation analysts when assessing economic damages.

Measurement of economic damages is usually required in the context of litigation: Something has gone wrong and a business has suffered loss, or at least that's what is alleged. The damage could be the result of a variety of distressing events — a breach of contract, theft, fire, flood or a bad business transaction, for example. The common denominator is that the business wants to be compensated for the damage done.

There are different types of economic damage calculations, and which type is appropriate depends on the facts and circumstances of each case. Assessing lost profits is among the most common types of economic damage calculations.

Calculating Lost Profits

Lost profits are generally determined by estimating the revenues that would have been achieved if the damaging act hadn't occurred. These estimated revenues are then adjusted by the costs that would have been necessary to generate that revenue.

For example, if a business shuts down for a period of time because of a spoiled ingredient or malfunctioning part provided by a vendor, the business would not be incurring certain costs — such as sales commissions or production expenses — during that time. These "unspent" monies would be deducted from the lost revenue amount.

But in some cases, costs are added rather than subtracted. For example, if the company incurs excess costs for clean-up after a flood, or pays an expert for reputation management due to a PR disaster, these costs would be added to the damage calculation.

Analysts use a number of different methodologies to measure lost profits, including the following:

But for: Using this method, analysts calculate what the profits would have been "but for" the damaging event. Some believe that this method produces the most logical results since factors such as economic conditions, competition, capital needs and capacity are reflected in the result.

Yardstick: This method compares the damaged company's results during the period of loss to the performance of similar companies during the same time period.

Before and after: In this method, analysts use the company's actual figures from the damage period. They compare performance prior to the damaging event (the base period) and after the damaging event (the damage period). The difference in performance between the two periods equals the loss.

Mitigation Required

In a lost profits calculation, there is generally a requirement that the business do what it can to mitigate the damage. For example, a manufacturing company would be expected to reduce the amount of incoming raw materials and associated costs if its production capacity were diminished due to a damaging event. Similarly, labor and maintenance schedules and costs would also be reduced.

Although determining the amount of lost profits seems straightforward, it is a complicated endeavor. In many cases, the calculation must eventually be defended in court. For these reasons, it's important to work with an analyst experienced in these types of calculations who can potentially serve as an expert witness if necessary. ■

Our team of valuation professionals can help you with all types of economic damages calculations. Call us today to discuss next steps.

Valuation Insights

Normalizing Compensation Reflects True Cash Flow

The U.S. Tax Court has been considering the issue of reasonable compensation since 1917. That's 99 years of litigation and thought on the subject, yet it's still one of the most debated topics in business valuation.

Reasonable compensation is considered to be a normalization adjustment made by valuation professionals to remove distortion of the company's operating performance. To reflect a realistic value, the analyst "normalizes" the company's cash flows by extracting any out-of-the- ordinary expenses or income.

Not surprisingly, compensation of owners and their family members is often out of the ordinary. Owners may pay themselves or their family members higher or lower salaries in order to minimize tax liabilities, influence the company's cash flow or value, or simply to conserve cash.

For example, owners might shift income to a family member in a lower tax bracket, take deferred compensation, or take their pay in a different form such as rent. Sometimes, no-interest or low-interest loans or non-deductible corporate distributions are disguised as compensation. And in some cases, family members are paid a salary but don't do much in terms of daily work at the company.

Quantifying "Reasonable"

For the purposes of a valuation, compensation must be normalized to reflect the salary and benefits a non-owner or non-family member would be paid to do the same work. To arrive at a "normal" non-owner, non-family compensation figure, analysts typically review:

- The employee's qualifications, background and experience.
- The nature, extent and scope of the employee's duties and the time spent performing those duties.
- The size and complexity of the business.
- Economic and industry conditions.
- Salaries and benefits paid to employees doing similar jobs in similarly sized businesses in the same area.

Because owners and family members may be receiving perks that wouldn't be paid to others, the analyst must also consider the entire benefits package. An automobile allowance, educational reimbursements, and insurance and retirement benefits might be reasonable for a replacement worker, but maybe not at the level currently given to owners and family members.

Another factor to consider is the cost to replace the owner or family member. Finding a new employee might require an expensive or time-consuming recruitment effort, or a signing bonus might be involved.

Industry Resources

Valuation analysts often turn to industry resources for benchmark numbers in their determination of what's reasonable. Trade associations, industry groups and consulting firms often provide these types of benchmarks, which are generally accepted as good inputs for comparison.

Among the more popular resources are U.S. Department of Labor statistics and the Risk Management Association's Annual Statement Studies. Also, the SEC and IRS issue publicly traded financial information and corporate financial ratios. For many industry categories — medical, manufacturing and banking, to name a few — analysts can find specific statistics to draw from.

Compensation adjustments can have a big impact on value, especially if the company's value is determined by a multiple of earnings. Therefore, normalization adjustments must be handled carefully. ■

If you'd like to discuss reasonable compensation further, please give us a call.

The Latest on Tax Affecting S Corporations

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is similar to the way analysts adjust for size, liquidity and other factors. But how much of the effect of embedded taxes should be removed?

Fannon and Sellers caution that the time horizon over which the tax effect is measured is critical. The sources most analysts use for their historical return data provide income returns over two time periods: 1926 to the present or 1963 to the present.

To calculate the embedded taxes, the analyst must choose the right time period and the right size of business. Then he or she must consider a number of other variables, including income and capital gain returns, tax rates and the holding period. Math — and more math — eventually results in a number reflecting the percentage of embedded taxes, and that number is then applied to the discount rate.

No Easy Answers

Fannon and Sellers acknowledge that their methodology results in only an "estimate" of the effect of taxes on C corp data. But they are confident they have proven that their theory is sound and is based on solid, peer-reviewed research.

Finally, the authors concede that "there are no easy answers" when it comes to tax affecting — and that the research has "further to go." ■

Interested in learning more about tax affecting S corps? Our valuation team is happy to answer your questions.

Discount Planning to Save Taxes Is Under Fire

It's common practice in estate planning to use partnerships, corporations and trusts as a means of transferring ownership of a family business to the next generation. When these ownership interests are valued for gift and estate tax purposes, the value is typically reduced due to discounts for lack of marketability and lack of control.

A discount for lack of marketability reflects the fact that the shares are closely held or restricted and thus cannot be easily sold or converted to cash like publicly traded stock could be. Similarly, a discount for lack of control reflects the fact that a minority interest owner in a company doesn't have the same power or control over day-to-day business decisions that a majority interest owner would have.

A discounted value is attractive in terms of estate planning, but the IRS has never been happy with this type of "discount planning." In fact, the use of these discounts has been under fire for many years. Last summer, the Treasury Department announced it would be issuing regulations that would limit or eliminate the use of discounts in family settings for the purpose of saving on estate taxes.

Discount planning is of special interest to those with assets close to or above the estate and gift tax exemption of $5.45 million, which translates to $10.9 million for a married couple for 2016. With the possibility of these new regulations in mind, it would be wise to proceed with discount planning and related valuations now.

The final guidance on the new regulations will be out soon, and it's likely that the new rules will restrict the discounts family business owners and estate planners have used for years. Will the regulations hold up in a court challenge? The valuation community will be watching closely. ■

Call our office today to discuss your discount planning options. We can help you devise the right strategy for your situation.