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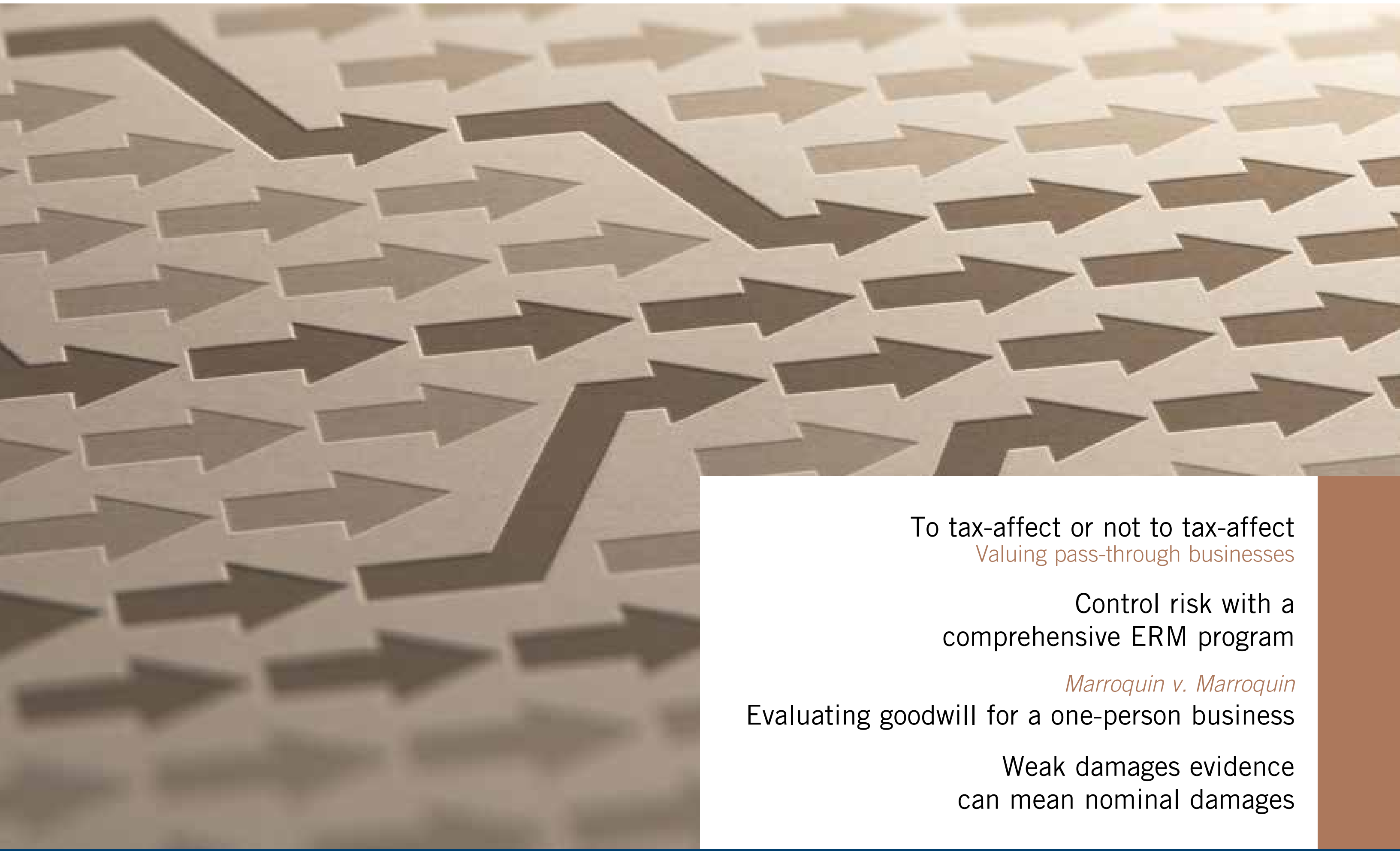

990 Stewart Avenue
Garden City, New York 11530

t: 516.288.7400
f: 516.288.7410
e: info@garibaldicpas.com

GARIBALDI
GROUP
Certified Public Accountants
Financial and Management Consultants

www.garibaldicpas.com

To tax-affect or not to tax-affect

Valuing pass-through businesses

The debate in valuation circles over tax-affecting has heated up in recent years. The IRS generally has opposed this practice of reducing a pass-through entity's projected future income for hypothetical corporate income taxes on that income. Likewise, the U.S. Tax Court has routinely ruled against tax-affecting. But other courts have allowed it in certain situations.

The case *for* tax-affecting

So-called "pass-through" entities — such as S corporations, partnerships and limited liability companies (LLCs) that are taxed as partnerships — are taxed only at the level of their individual owners. When valuing a business, many experts favor tax-affecting the earnings of pass-through entities. They argue that a hypothetical buyer of a minority interest in such an entity would be aware it would be taxed at its ordinary-income tax rate on its share of income and gain, regardless of whether any dividends are distributed. Hypothetical buyers also might consider the possibility that the business could lose its pass-through status.

Moreover, pass-through entities typically are valued using an income approach. Because appraisers have no market to refer to, they must develop discount rates (essentially, the required rates of return) based on data derived from the earnings of C corporations that have paid corporate-level income tax. Tax-affecting, therefore, is necessary to avoid inflating the value of pass-through interests, which aren't exempt from paying taxes.

> The Tax Cuts and Jobs Act could affect the debate over tax-affecting going forward.

The case *against* tax-affecting

Tax-affecting opponents got a boost from the Tax Court's 1999 decision in *Estate of Gross v. Commissioner*, which was affirmed in 2001 by the U.S. Court of Appeals for the Sixth Circuit. The court held that tax-affecting was inappropriate because S corporations possess significantly more value than C corporations due to their preferential tax treatment. That is, investors in C corporations are taxed at both the corporate entity level and the individual level when distributions are made to shareholders.

The Tax Court subsequently rejected tax-affecting in several more cases. In each, it found that, in applying an income approach to the pass-through entity's earnings, the proper entity-level tax rate was 0%.

In 2014, the IRS issued a guide for valuing minority interests in S corporations. It reasons that, if a mixed pool of potential buyers exists for such an interest, the buyer that would benefit from an S corporation's pass-through taxation will drive the ultimate transaction price, all other things being equal. The guide concludes that no corporate tax should be applied without compelling evidence that independent third parties dealing at arm's length would do so as part of a price negotiation.

Despite this guidance, the IRS recently engaged in tax-affecting itself. In *Kress v. U.S.*, a case involving the gift tax on the transfer of shares in a family-owned business, both sides' experts tax-affected the company's earnings. The federal district court for the Eastern District of Wisconsin accepted the methodology without extended discussion.

Role of the TCJA

The Tax Cuts and Jobs Act could affect the debate over tax-affecting going forward. Various provisions, including the reduction of the corporate tax rate to 21% (compared to a top individual rate of 37%), may make pass-through status less attractive.

While the law creates a new qualified business income deduction for pass-through entities, it's subject to numerous limitations. It's also set to expire after 2025. On the other hand, the corporate tax rate is permanent. Of course, both changes could be eliminated, depending on the results of the 2020 elections.

Stay tuned

The future of tax-affecting when valuing interests in pass-through entities remains uncertain. But recent court decisions indicate a growing acceptance of the practice when qualified business valuation experts present the appropriate support. ■

Has the Tax Court changed its stance?

In August 2019, the U.S. Tax Court approved the use of tax-affecting in a gift tax dispute (*Estate of Jones*). The question, the court said, isn't whether to account for the tax benefits of a pass-through structure — but how.

The case involved the valuation of transferred equity interests in two pass-through entities. The taxpayer's valuation expert tax-affected the companies' earnings by combining the federal and state tax burdens the owners would bear if the companies were C corporations.

The IRS (notably, through its lawyer, not its valuation experts) argued that the taxpayer's experts shouldn't have tax-affected the company's earnings. Rather, a 0% tax rate appropriately reflected the companies' pass-through status.

The Tax Court distinguished the case from earlier decisions rejecting tax-affecting. It noted, for example, that it was presented in *Gross* (see main article) with a choice between a 40% or a 0% corporate tax rate. In other cases, it disallowed tax-affecting because the taxpayer's expert hadn't justified it or had used a "faulty" method.

In the *Estate of Jones*, however, the taxpayer's expert "more accurately" took into account the tax consequences of the companies' pass-through status. His adjustments included a reduction in the total tax burden by imputing the current tax an owner might owe on the earnings and the benefit of a future avoided dividend tax.

The Tax Court conceded that the expert's tax-affecting might not be exact. But, it found that the methodology used by the estate's expert was "more complete and more convincing" than the IRS's 0% tax rate.

Control risk with a comprehensive ERM program

Risk is part of owning and operating a business. But excessive levels of risk can impair value, consume working capital and eventually lead to bankruptcy if left unchecked. Although business owners can't eliminate all risk factors, they can manage their risk profiles by implementing an Enterprise Risk Management (ERM) program.

The basics

According to the Committee of Sponsoring Organizations of the Treadway Commission (COSO), ERM is "a process … applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives."

ERM goes beyond internal controls. It should be a top-down directive that infiltrates all levels of an organization. Effective ERM helps managers accomplish their strategic, operations, reporting and compliance objectives.

Siloed vs. integrated approach

Traditional risk management techniques — which often are informal and ad hoc — use a "siloed" approach. In other words, each department in a company focuses on minimizing its own risks. This isolated approach is ineffective, because it wrongly assumes that the goal of risk management is to eliminate risk. Rather, the goal is to optimize risk, or to promote the company's strategic objectives while maintaining an acceptable level of risk.

By comparison, an ERM program takes an integrated approach to managing risk, recognizing that many risks are enterprisewide and interrelated. Consider a bank whose loan review department evaluates credit risk based only on potential financial losses from a borrower's default. If the bank

used ERM, it might also consider the risk that an increase in foreclosures would damage the bank's reputation. In other words, the risk associated with bad loans extends well beyond lost receivables or the financial cost of foreclosure.

Reluctance to adopt

Despite the potential benefits ERM offers, many companies — both public and private — have been slow to implement ERM. One reason is the perception that adopting ERM is a complex, expensive undertaking. While it's true that developing an enterprisewide system for evaluating and managing risk is a major project, the benefits can be significant and generally outweigh any cost or inconvenience.

Companies may also be slow to embrace ERM because, to be effective, an ERM program must be highly customized. Guidelines are available, such as COSO's *Enterprise Risk Management — Integrated Framework*. But these guides must be carefully tailored to the company's culture.

Implementation tips

COSO's paper suggests companies start by focusing on a small number of critical risks. Other tips for easing into ERM include the following:

- Leverage existing internal audit and accounting department resources, rather than creating new positions and hiring new people to fill them.
- Select a strong leader to drive the ERM initiative and guide the risk management committee.
- Inventory current risk management practice and IT resources, and then build on them.
- Make ERM part of the company's core business processes, rather than a separate unit or function.
- Educate management about ERM best practices and new regulations.

The guide emphasizes that the components of an ERM program need not be implemented all at once. An incremental approach that begins with relatively simple processes and builds the program over time can be just as effective. And this approach gives the board and senior management time to learn about and evaluate the benefits of each step — increasing support for the program.

For more information

Many businesses wait until they're already in trouble before they address risks. But crisis management tactics provide only quick fixes for symptomatic problems. Ask your clients about their ERM initiatives. If they don't have any, suggest that they work with a forensic accounting expert to develop an ERM program and improve their risk profile. ■

Marroquin v. Marroquin

Evaluating goodwill for a one-person business

In divorce cases, the treatment of a closely held business's goodwill varies from state to state. It also depends on the nature of the business. Here's a recent Utah appeals court case that addresses this issue.

What is goodwill?

The settlement process is more complicated when a marital estate includes a private business interest. The owner-spouse may want to continue operating the business after the divorce is settled. So, selling the business might not be an option. Instead, the business interest must be valued and included — either entirely or partially — in the marital estate.

Many businesses possess intangible assets, such as patents, customer lists, brands and goodwill. Some states include all intangible assets in the marital estate; others exclude goodwill. But the majority, including Utah, require goodwill to be broken down into two components:

1. Personal (professional) goodwill. This component is tied to the owner-spouse. It's a function of his or her reputation, skills and personal efforts. Other factors to consider include the age, health and retirement plans of the owner.

2. Enterprise (institutional) goodwill. Also referred to as "business" goodwill, this component is linked to the entity and can be sold to a third party. It's associated with companies that have established brands, accessible locations and an assembled workforce.

In jurisdictions that make this distinction, personal goodwill is generally excluded from the marital estate if the nonowner-spouse receives alimony from the owner-spouse.

Case in point

In *Marroquin*, the husband owned 99% of a vending machine business that he'd started before the marriage. The company operates 87 vending machines and three self-serve kiosks in various locations throughout Salt Lake City.

The husband was the business's only employee. He had built long-term relationships with property owners who had the contractual right to replace vending machine providers on a monthly basis. The wife's involvement in the business was "minimal."

After the wife filed for divorce, the value of the business became a central question in dividing up the marital estate. Both sides hired outside experts to value the business. The wife's expert was a CPA with no business valuation credentials.

Using the income approach, he computed a value of approximately $700,000, including "goodwill associated with the business."

The husband hired a CPA who "devotes approximately 75% of his practice to performing business valuations and testifying as an expert." Using an asset-based approach, he valued the business at $152,937, including a 5% discount for lack of marketability. He opined that the company had no institutional goodwill. The expert explained that, "without the relationships that exist for the places where the vending machines are located, there is no potential for goodwill. There's no income earning capacity that would be in excess of the value of the assets."

> Enterprise (or institutional) goodwill is associated with companies that have established brands, accessible locations and an assembled workforce.

The district court sided with the husband's expert, awarding alimony and half of the business's net tangible value to the wife. The wife appealed, challenging the lower court's determination that any goodwill was personal to the husband.

Decision upheld

The Utah Court of Appeals agreed with the district court. It found that the company's goodwill was solely attributable to "[the husband's] work, his efforts, and his reputation for competency." Moreover, his personal relationships with property owners allowed him to continue to conduct business, largely on a month-to-month basis. The court also likely factored into its final decision the fact that the wife's expert lacked business valuation credentials.

As this case demonstrates, the appropriate treatment of goodwill can be a contentious issue. For more information on how goodwill should be treated in your jurisdiction, based on the nature of the business, contact a credentialed business valuation specialist. ■

Weak damages evidence can mean nominal damages

A start-up company lost out on a jury's $4.35 million lost profits award in a breach of contract action after a federal court found its expert's "yardstick" analysis faulty. The decision by the U.S. Court of Appeals for the Second Circuit to uphold a $1 damages award serves as a strong reminder that establishing liability is only half the battle. A solid estimate of damages also is critical to recovering losses.

What happened?

In November 2013, a start-up company entered an agreement giving the defendant an exclusive license for the company's athletic compression wear products. A potential deal to partner with MTV to promote the brand and generate hundreds of millions in product sales failed to materialize. So, the defendant terminated the agreement in March 2015.

The start-up sued, seeking more than $50 million in damages. Its expert relied on a yardstick analysis to estimate damages. The analysis used Under Armour, the market leader in compression wear, as the sole yardstick (or comparable).

After trial, a district court vacated the jury's damages award, finding it too speculative, and ordered a new damages trial. The court reviewed the evidence the company presented at retrial, and it evaluated the company's theory that it should receive several million dollars more than the jury award. Then it reconsidered the order and entered judgment as a matter of law for $1. The start-up appealed.

How much was awarded on appeal?

On appeal, the Second Circuit concluded that the start-up had failed to present sufficient evidence from which lost profits could be established with reasonable certainty. It also decided that Under Armour wasn't a reasonable yardstick. At the relevant time, Under Armour was an established business with annual sales between $49.5 million and $195 million and controlled about 80% of the market. By contrast, the start-up had sold less than $200,000 to only a few small retailers, high schools and college teams.

The appellate court affirmed the lower court's ruling. It found the expert's assumption that the start-up's revenues would jump to roughly $80 million in two years was "so unfounded that it failed to establish any legal basis for awarding lost profits damages." The expert used what's referred to as a "hockey stick approach," assuming that revenue would skyrocket to an amount that's unrealistic, unreasonable and without a credible evidentiary basis.

Lesson learned

Before relying on an expert's analysis, it pays to ask: Does this conclusion seem reasonable? Speculative, unsupported or unreasonable awards that don't stand up to a "sanity check" are unlikely to survive on appeal and can lead to years of costly litigation and, ultimately, nominal damages awards. ■

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