

ADVOCATE'S EDGE



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Tax Court permits tax affecting of S corp earnings

The debate about tax affecting when valuing pass-through entities for federal gift and estate tax purposes continues. “Tax affecting” refers to the practice of reducing a business’s projected future earnings for hypothetical corporate income taxes. For this purpose, pass-through entities may include sole proprietorships, partnerships, limited liability companies and S corporations. In general, the IRS contends that tax affecting is improper, and the U.S. Tax Court has generally agreed. However, the court allowed it in a recent case.

Background

In *Estate of Cecil v. Commissioner*, gifts of noncontrolling stock in The Biltmore Company were transferred to family members in 2010. The company had elected S corporation treatment for federal income tax purposes in 1982. The shareholders subsequently instituted several agreements and policies to ensure continued family ownership.

Each donor (a husband and wife) filed a gift tax return that reported total combined taxable gifts of about \$10.4 million. The IRS determined

a \$13-million deficiency for each return. The donors appealed.

To tax affect or not?

In determining the fair market value of the gifted shares, the experts for both sides tax affected earnings. They reasoned that, while S corporations don’t generally pay entity-level income tax, the data used to value S corporations comes largely from data on C corporations, which *do* pay entity-level tax.

Both experts applied the S corporation economic adjustment multiple (SEAM) model. This technique values an S corporation’s shares as if the business paid the same level of taxes as a C corporation, but it also factors in the tax *advantages* of operating as a pass-through entity. The IRS expert determined the rate should be 17.6%, while the taxpayers’ expert used a rate of 24.6%.

The Tax Court cited several previous cases where tax affecting was disallowed when valuing pass-through entities. For example, in *Gross v. Commissioner*, the court concluded that the principal benefit that



Earnings vs. assets: Which drives value?

In *Estate of Cecil v. Commissioner*, the U.S. Tax Court rejected the IRS expert's application of the asset-based approach to value The Biltmore Company's shares. The court found that the company's *earnings* were the best measure of the fair market value of the shares, noting that it wasn't a holding company and liquidation was unlikely.

The court rejected the IRS argument that shareholders' testimony about a lack of plans to sell shares or liquidate was "self-serving." It found documentary and other evidence supported the testimony, establishing that the shareholders aspired to keep the business in the family by restricting stock transfers to outsiders. The business had been in the family since its incorporation in 1932.

shareholders expect from an S corporation election is reduced total taxes. So the court reasoned that those savings shouldn't be ignored when valuing an S corporation. But the court also noted that prior case law never prohibited the use of tax affecting when circumstances call for it.

Tax affecting isn't always a proper consideration when valuing an S corporation.

In *Cecil*, both experts agreed that the S corporation's earnings should be tax affected to value the subject stock, and both used the same tax-affecting model. Given the "unique setting," the court found that tax affecting was appropriate. However, it cautioned that tax affecting isn't always — or even more often than not — a proper consideration when valuing an S corporation.

Current challenges

Cecil pre-dates the Tax Cuts and Jobs Act (TCJA), which helped level the tax playing field for pass-through entities and C corporations. Before the TCJA, the IRS had successfully argued in several landmark cases that tax affecting wasn't appropriate for pass-through entities because they weren't subject to the entity-level C corporation income tax.

The TCJA permanently reduced the federal tax rate for C corporations to a flat 21%. It also created a

temporary special tax break for pass-through entities to help achieve parity between the reduced corporate rate and the rates for income that passes through to owners of pass-through businesses. The qualified business income (QBI) deduction allows eligible owners to deduct 20% of their QBI. But not every pass-through entity qualifies for the deduction — and it doesn't always equal the full 20%.

Further, the QBI deduction is set to expire in 2026, unless Congress extends it. In that case, pass-through business owners could be subject to rates as high as 39.6%. (The lower individual tax rates under the TCJA are also set to sunset after 2025 absent congressional action.)

Prior to the TCJA, pass-through entities offered significant tax advantages. The IRS cited these benefits as a reason to reject tax affecting. However, as long as TCJA rules are in effect, pass-through entities and C corporations face comparable tax treatment, which strengthens the argument for tax affecting. If the favorable tax provisions for pass-through entities are allowed to expire and the corporate rate remains at only 21%, the tax advantages of operating as a pass-through entity will diminish even further.

Going forward

The Tax Court's reluctance to expressly embrace (or disallow) tax affecting creates uncertainty when valuing S corporations and other pass-through entities for tax purposes. A qualified valuation expert can help evaluate whether it might be appropriate based on case facts. ■

Ransomware attacks on the rise

Cyber insurance providers — including Marsh and Resilience — are reporting upticks in ransomware claims in 2023, compared to 2022. So far this year, several well-known brands have fallen victim to these attacks, including Dole Foods, Dish Network and Yum brands (the parent company of KFC and Taco Bell).

In March 2023, the White House unveiled its National Cybersecurity Strategy. It classifies ransomware attacks as a national security threat and calls for the United States to pursue “a more intentional, more coordinated, and more well-resourced approach to cyber defense.” Companies that commit to a similar approach can help prevent, detect and respond to attacks, thereby minimizing damages and reputational harm.

How hacks happen

Ransomware is a type of malware that, once downloaded, prevents access to computer systems or files until the user meets the perpetrator’s payment demands. The underlying cause is often a malicious email that’s sent to an employee. Malware may be embedded in attachments, or the email might contain a link to a website that will install malware on the user’s computer and, from there, infiltrate the network. Frequently, the email appears to come from legitimate business partners, co-workers, law enforcement officials or IRS representatives.

Another threat is malicious *advertising* that infects a user’s computer with little or no interaction. For example, an employee might encounter “malvertising” while browsing

the internet. A malicious site may deliver the ransomware directly or be used to launch an attack against a targeted user.

Once a device has been compromised, the perpetrator gains a foothold in the user’s IT environment. Until the breach has been detected, the hacker is free to explore the user’s network for vulnerable systems and data and to encrypt data indiscriminately. Then the hacker can demand a ransom for the decryption key needed to restore network access.

How to prevent attacks

Organizations should take proactive steps to protect their networks. These include:

Training. Employees should know the mechanics of ransomware attacks and why opening unsolicited emails and searching unsecure websites can be harmful. Companies should require staff to complete regular cybersecurity training sessions. Then test emails can be used to simulate ransomware attacks and assess whether training has been effective.

Security products. Antivirus software, firewalls and email filters can be installed to keep external



hackers from accessing users and networks. It's also important to update all operating systems and applications on users' computers. Perpetrators target vulnerable systems and applications.

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Backups. Ransomware victims that regularly back up files may be able to restore their networks. The keys are early detection and backup storage on devices that are separate from infected networks, such as external hard drives or Cloud servers.

Insurance. Professional and general business liability insurance policies generally don't cover ransomware losses. So, many organizations buy cyber liability and breach response insurance to fortify their defenses. These may be separate policies or add-ons to

existing policies and generally cover a variety of risks, depending on the policy's scope. Insurance typically protects against liability or losses from unauthorized access to electronic data and software. But policies should be carefully reviewed to understand what's specifically *excluded* from coverage.

What's the right response?

Unfortunately, preventive measures sometimes fall short. Organizations that become ransomware victims may be tempted to quickly pay the ransom to minimize losses. But paying ransom can be costlier than restoring data from backup files or other means. Plus, there's a risk that criminals won't hand over a decryption key once they have the money.

Cyber insurance providers, attorneys and financial advisors can work together to help clients determine the appropriate course of action. This includes reporting the incident to law enforcement; restoring systems; and communicating the effects to employees, customers and other stakeholders. ■

Due diligence is critical when buying a distressed business

In the aftermath of the COVID-19 pandemic and the ensuing market volatility, some businesses are struggling to survive. A distressed business may be a prime target for a takeover — but due diligence is critical to avoid overpaying. After all, buyers don't want to inherit the sellers' problems.

Watch for deal breakers

Distress sales and auctions may offer bargains, but buyers shouldn't let rock bottom prices cloud sound business judgment. Bringing in a valuation professional who can accurately assess and benchmark financial health against industry norms is a must.

Financial statement trends, such as recurring net losses and declining sales growth, are common symptoms of a company in trouble. Others include missing financial records, fully extended lines of credit and denials for credit extensions. In addition, a business in trouble may be operating in the red and liquidating fixed assets to generate cash.

When valuers address these companies, they can modify their approach to avoid over- or under-valuing a distressed business. They can also provide insight into the details of sales of comparable distressed businesses from proprietary transaction databases.

Assess value

When buying a distressed company, *liquidation* value is sometimes more important than *going concern* value — especially if the seller is under duress to exit the business. If liquidation value is the “floor” for purchasing a distressed business, strategic value is the “ceiling.”

Financial distress creates specific valuation challenges. First, it’s unlikely that a distressed business’s historic financial performance will offer insight to its future performance. Future cash flow is important because it determines value under the income and market approaches.

If liquidation value is the “floor” for purchasing a distressed business, strategic value is the “ceiling.”

If turnaround plans exist and seem reasonable, valuers may use these estimates to forecast future cash flow. If not, they might work with management to project future cash flow based on *expected* demand, not past performance.

Financial distress adds an element of risk, which lowers value. So, compared with healthy companies, distressed businesses generally warrant higher discount rates and receive downward adjustments to pricing multiples. Valuers might select guideline companies based on similar financial performance or a proximate transaction date to avoid using deals that occurred during better economic times.

Finally, liquidation value plays an increasingly important role in valuing distressed companies. Here, valuers consider what the business would receive in an orderly disposition or at an auction — and then subtract outstanding debt obligations.

Evaluate financial metrics

There are several tools that can help buyers evaluate whether asking prices make sense, including:

Accounting payback period. This metric estimates how long an investment will take to recoup its initial cost.

Breakeven point. Breakeven predicts how many units must be produced to cover incremental costs. If sales volume exceeds breakeven, an investment will generate profits.

Net present value. Here the analyst converts an investment’s projected cash flows to present values using an appropriate risk-adjusted discount rate. If net present value is greater than zero, an investment may make sense.

Experienced valuation professionals can help crunch the numbers to determine whether a target’s asking price seems reasonable. They can also devise alternative deal terms to bridge the gap between the seller’s asking price and the amount a buyer is willing to pay.

Do your homework

Despite today’s uncertain market conditions, buyers may find opportunities to acquire a suitable company at the right price. But comprehensive due diligence is essential before signing on the bottom line. ■



Apportionment: Does your damages expert understand this legal concept?

In *Niazi Licensing*, the U.S. Court of Appeals for the Federal Circuit excluded the testimony of a damages expert on the proper royalty rate for an infringed method patent. Where did the expert go wrong?

District court excludes expert

The patent in question covered a double catheter structure used in the treatment of congestive heart failure. The patent holder sued another medical device maker for infringement. One of the allegedly infringed claims covered a method for implanting an electrical lead into a vein using a double catheter. The method involves a lead, a guide wire, an inner catheter and an outer catheter.

The defense expert proposed a 14.6% royalty rate for infringement of the claim. As for the royalty base, he concluded — without explanation — that a royalty based on the alleged use of the method would be impractical. Instead, he determined that the royalty base should include sales of all four components.

The U.S. District Court for the District of Minnesota excluded the expert's opinion as legally insufficient because 1) he failed to “apportion” between infringing and noninfringing uses of the components, and 2) he couldn't properly include leads in the royalty base. The defense appealed.

Court of Appeals affirms

The Federal Circuit affirmed the district court ruling, enumerating multiple problems with the defense expert's “conclusory and legally insufficient” analysis. It found that the expert didn't explain why a royalty based on the method's use would be impractical. The expert also didn't attempt to value any efficiencies or patient health



advantages gained by practicing the patented method rather than nonpatented methods — or explain why this couldn't be done. Similarly, he didn't cite any other evidence related to the patented method's value compared with other methods — or explain why such a valuation wasn't possible.

In addition, the court faulted the expert for including in his calculation sales of the defendant's outer catheters, inner catheters, guide wires and leads — even though it was undisputed that not all of the sold components had been used in the patented method. It found the failure to account for noninfringing uses was “legally improper,” rejecting the plaintiff's argument that apportionment doesn't apply to method claims. Where the only asserted claim is a method claim, the court said the damages base should be limited to products that were used to perform the method.

Build a better case

Notably, the Federal Circuit found that the expert didn't address or rely on any evidence that estimated the amount or percentage of sold components that were used to infringe the claimed method. Such evidence, it said, might include testimony of users of the method, other anecdotal testimony or survey evidence. ■



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