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What About IRC 2704 Regulations Now that the U.S. Has New Leadership?

As discussed in the Winter 2016 issue of this newsletter, the Internal Revenue Service was making a strong push to outlaw most valuation discounts through proposed regulations. Now that the country's newly-elected executive has indicated that the estate tax would be repealed, what of the proposed regulations?

In fact, no one knows, and uncertainty remains high. No consensus exists at this point early in the new administration. According to a mid-Atlantic law firm, even with Republican majorities in both houses, passage of any new estate tax law still requires Democratic support. Accordingly, a compromise on any estate tax repeal is likely this year. Several observers have indicated that the regulations are on indefinite hold, but may come back, perhaps around May.

Due to changes in the political landscape and the uncertainty of tax law changes, the proposed regulations will not become final or implemented any time soon. As a result, many clients may want to adopt a "wait and see" attitude and defer moving forward with the type of planning involving discounted interests in closely-held businesses or other entities. However, for asset protection or family planning, now may be as good a time as any to put the planning in motion.

President Trump during his campaign proposed replacing the estate tax with a capital gains tax on amounts over $10 million, similar to the law in Canada. Of course the same valuation issues would likely come up again in that eventuality. The President has not commented on the associated gift tax nor the generating-skipping tax. If the regulations are not repealed, valuation rules would split between at death valuation and other types of tax valuations, a very confusing system.

U.S. Law Firms are Merging, Many with Overseas Target or Buyers

According to a release by Altman Weil, a consulting firm for law firms, 2016 was the 4th year in a row when law firm mergers were higher than the preceding year. In fact, there were 85 law firm combinations last year. 2013 was the first year during which firms merged in record number, as they were facing the end of a sharp recession; mergers and acquisition activity has kept pace since with a modest year to year increase. Most of the mergers announced last year involved relatively small firms. Most 2016 mergers were justified as the easiest way to grow revenues in the current environment of flat-line demand and the ability to offer a broader range of services.

Some of the largest acquisitions by a U.S. based law firm last year involved consolidating with French or Canadian firms, while several London-based firms acquired regional American firms. Also significant was the merger of Arnold & Porter, Kaye Scholer and others resulting in a mid-Atlantic domestic giant of over 1,000 lawyers. Other New York based firms also acquired California-based law firms, while others were active in their own markets.

Duff & Phelps Reaffirms the Equity Risk Premium [ERP] and Lowers Normalized Risk-Free Rate

Fluctuations in global economic and financial conditions warrant periodic reassessments on the ERP and accompanying risk-free rate. Duff & Phelps, the publisher of the annual *Valuation Handbook*, has just reaffirmed its U.S. ERP recommendation at 5.5%, to be used in conjunction with a risk-free rate which it lowered from 4.0% to 3.5%. The later is based on declining real interest rates and long term growth estimates. The resulting minimum cost of equity rates will be used by appraisers who follow D&P [including JLP&Co.LLC] starting with valuation dates of November 15, 2016 until further notice. Normalized risk-free rates are used when money market rates are unusually low as a result of central bank intervention going back many years.

Healthcare M&A Deal Volume Up in 2016, Spending Down

According to Irving Levine Associates, a consulting firm specializing in the healthcare sector, that sector's mergers and acquisitions market was up 1% to 1,536 transactions, but they represented $255 Billion, down 36% from $400 Billion. Sub-sectors showing the greatest increase year to year were: eHealth [+23%,] rehabilitation [+21%,] and physician medical groups [+19%.]

The consulting firm further suggests that the market for physician groups is likely to continue strong, due to the uncertainty surrounding the potential repeal and replacement of the Affordable Care Act. Many physician groups have partnered with hospitals because they see difficult times ahead, especially if they have not developed a specialty niche.

Washington State Court Clarifies Double Dip Analysis

Double dip - or how the division of assets and support are related in a divorce - is challenging for appraisers because state laws have handled it differently. A recent Appeals Court decision in the state of Washington however clarifies the rules. The trial court awarded to the non-owner spouse both half the value of a management consulting business, which the husband had founded and grown during the marriage, and support payments of $640,000 over 44 months [the business interest would also be paid in installments.] The value of the business was determined by "splitting the difference" between the 2 experts. The court recognized that the business has significant goodwill, and is more likely than not to continue generating good growth in the future.

Under state statutes, the division of property is only one of the factors which must be considered when determining support. The only limitation is that it be "just." The law states that "when property awards and support are paid from the same asset in a manner that unfairly burdens the payor-spouse, the maintenance award duplicates the property division." Unfairness comes into play when the divided asset is a diminishing asset that does not generate significant or any future income for its owner.

In this case, the management firm was expected to thrive, and the husband was not required to erode the company's value to pay maintenance. Accordingly, the appeals court upheld the maintenance award. The case is In re Marriage of Cheng, 2016 Wash. App. Division II No. 47937-1-II [Lexis 2854] dated November 22, 2016 and can be found at http://www.courts.wa.gov Look for an unpublished opinion of the appeals court, division II, case No. 47937-1-II [unpublished.]

Washington is a community property state, but this does not make the appeals ruling less important in general, except for the inclusion of the business in the marital estate. Accordingly, the case decision could clarify matters in non-community property states as well. Based on the Appeals Court' interpretation of in-state precedents, a distinction is made between businesses whose future cash flows represent a return on the assets already valued and reflected in the marital estate, and businesses that are expected to grow and where future cash flows are a return on that asset. Future income growth is an underlying assumption in the vast majority of income-based approaches to value.

Appraisal Review & Management: What Is it?

ARM is the process by which a valuer reviews another valuer's work product, and comments on adherence to standards, to key tax rulings, methodology and other aspects in order to help the client or a court decide how much weight to accord to the original work product. ARM applies to any field of valuation, such as real property or business valuation. JLP&Co.LLC has performed several business valuation reviews in the past at the request of client-attorneys.

ARM is governed by Standard 3 of USPAP. Now that the American Society of Appraisers has established a separate course of study, education and certification/designation for ARM, this appraiser will take the relevant ASA courses starting during the 2nd quarter of 2017.

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business communities from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder and corporate disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which may affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of an attorney.

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