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Constantly Re-Calculating Valuation Models in Mid-market Businesses: Is It a Good Idea ?

The New York Times, in its January 30, 2013 issue, wrote about a specialty manufacturing business whose owner had installed valuation software re-calculating company value on a real time basis. The model adjusted value for each significant revenue increase, expense reduction, pricing change or relevant market transaction. The owner of the business thought highly of the resulting information and indicated that the additional knowledge was well worth the cost.

Is it possible to value a business based on a few formulas? If it is, and assuming further that the owner is familiar with business pricing methods of the industry [in order to focus on the more relevant model output,] would a few tweaks really change what he could sell the business for?

As a generality, we do not think so and we have a better solution. Even the NYT article quoted a Mergers & Acquisitions professional saying that “there is something to be said for having a person trained in business valuation come in and get to know the business before running the numbers.” Instead of using automatic models, I would certainly recommend that a business owner with a medium to short term interest to sell engage a qualified business appraiser on the following basis.

A limited appraisal can be produced [no narrative, just spreadsheets] which actually answers the owner’s questions and prepares for the work ahead. When this type of inquiry has come into this practice in the past, we were able to provide the missing pieces to the owner’s perception of what was needed in order to effect a successful sale. In each case, relatively few hours were necessary to get up to speed on how the business was functioning and provide a detailed review of past achievements. The output included an analysis likely to be undertaken by prospects, and a list of issues which appeared critical. From that information, the owners were able to anticipate what buyers would be interested in and prepare accordingly. If nothing else, the work we did kept future prospects “honest.”

A business appraiser will not find you an acceptable buyer; only a well-connected broker will. However, the business appraiser will prepare management for not only what the prospective buyer will ask for but also the necessary efforts to make the business more attractive to potential buyers. It turns out that a business appraiser can indeed help smooth out the selling effort of a business.

The Forbes article

In its March 4, 2013 issue, under the by-line of Daniel Fisher, Forbes would have you believe that three formulas constitute safe-harbor in order not to run afoul of the IRS in truly difficult-to-value private investments. The article cites a Delaware corporation collecting a dividend, through a minority investment in a large, profitable conglomerate in fact controlled by insiders and trusts. Add complexity in the form of various governing agreements which Forbes did not have access to. Add the privacy-loving insiders and the fact that, despite their best efforts, their family has not been immune to the gossip columns. You would end up with an extremely fact-specific problem which no pre-determined formula can help, but which most business appraisers would enjoy working on.

Forbes suggests a lack-of-control discount calculating using the inverse of the average premium paid for solicited public stocks, despite the fact that restrictions on minority investments can range from slightly to highly restrictive. Forbes also postulate that a discount for lack-of-marketability be based on pre-IPO studies and the pricing of private equity fund stakes, despite lack of consensus in this area and, as a result, the practical necessity to use more than one tool to support a discount. Finally, Forbes suggest using real estate partnership data studies, even though their dwindling numbers render this methodology difficult to support except in very few special situations.

By publishing such “safe formulas,” Forbes is unfortunately disseminating unhelpful information and providing a dis-service to all interested in private business valuations. Perhaps our profession should monitor what the financial press publishes - or does not publish - and set the record straight in our own area of expertise.

Estate of Virginia Kite v. Commissioner T.C. Memo 2013-43 filed February 7, 2013

This important decision allowed a decedent to exclude from her estate a significant amount of wealth by using annuities tailored to the best estimate of her medical condition. Perhaps others could use this method to lighten their estate for tax purposes. In 2001, Mrs. Kite was 74 old, not terminally ill but in poor health and desirous to do more estate planning. Mrs Kite was sophisticated in business and legal matters; her attorney suggested a simple method to take assets out of her trusts to benefit her children: using a private deferred annuity.

In 2001, her trusts sold their remaining interests in Kite Family Investment Co., a Texas general partnership, in exchange for 3 deferred private annuities each for the benefit of each of her 3 children. KIC held notes, various investments and publicly traded securities. The KIC interests were valued at $10.6 million when transferred and the valuation used the liquidation value; the annuities were valued under the rate prescribed by IRC section 7520 and the IRS actuarial tables prescribed by Notice 89-24 [1989-1.]

Each of the private annuities provided income, but that income was deferred for ten years since Mrs. Kite did not need current income for the foreseeable future. The question posed by the Tax Court: since no money changed hand, was this a sale for full and adequate consideration of the KIC interests ? The Service did not think so, on the belief that the transaction was merely a disguised gift. Both a notice of deficiency relating to the gift return and another relating to the estate return were sent by the Service upon Mrs. Kite's death. Mrs. Kite died 3 years after the annuities were exchanged for the KIC interests.

As the decision of whether the March 2001 transfers were for full and adequate consideration is entirely dependent on the value of the annuities, that's where the Court turns first. Specifically, was it appropriate for the decedent to have relied on standard mortality and valuation tables to value the annuities, when her health at the time was failing? In reaching the decision that it was reasonable, the Court relied on the *McLendon* decision [135 F3d 1017 [5th Circuit 1998] revising T.C. Memo 1996-307] and the following:

1. As established in *McLendon*, the party attempting to depart from the tables has the burden of proving such departure is justified.

2. The Regulations provide that the mortality component of the actuarial tables may not be used to determine the present value of an annuity if the taxpayer is terminally ill. And terminal illness is defined as a condition where the resulting chance of death within one year is at least 50 percent.

3. While Mrs. Kite was in declining health as of the transaction date, she was able to get a letter from her physician attesting that he had examined and interviewed her at her home and "would anticipate that her longevity and health outlook is good for the next several years" that she was "not terminally ill" nor did she have "an incurable illness or other deteriorating physical condition that would cause her to die within one year". The physician estimated that her probability of surviving 18 months or longer was "at least 50%".

4. While Mrs. Kite was receiving home health care beginning in 2001 and was incurring substantial medical expenses, the Court notes that the expenses were mostly due to Mrs. Kite's decision to receive health care in her home [her prescription drug expenses, for one thing, were minimal] and that her decision to receive health care at home could simply be explained by the fact that she could afford it.

5. The Kite children were also affluent, after several rounds of gifts, and could have afforded to pay the annuity, at least for a while, had Mrs. Kite survived the ten-year deferral period.

6. Mrs. Kite had access to enough other assets that she didn't really need the income flowing from the KIC interests and it was thus reasonable for her to "risk those interests for the potential *profit* in the annuity transaction." The existence of her profit motive is further supported by her "position of independent wealth and sophisticated business acumen."

It does seem quite a stretch to conclude, as the Court did based on the foregoing, that "Mrs. Kite and her children reasonably expected that she should live through the life expectancy determined by the IRS actuarial tables, which was 12.5 years". It certainly seems, however, that it is more reasonable to conclude that they expected she would not and structured the transaction accordingly. However, if the standard in any case is only that she was expected to live more than a year, this may not be particularly important. And since the March 2001 transfer was for full and adequate consideration, the Court also rejects the respondent's argument that the annuity transaction lacked economic substance.

Did the Service make another unforced error here? By providing such an easy win for the taxpayer, did the decision open up a huge new estate planning opportunity for the wealthy? The Court's decision here provides wide leeway for such transactions going forward. There must be a substantial number of clients for whom life expectancy is more than one year, but where the probability of outliving a set number of years [could be any number of years] is negligible. Such clients would have the ability to transfer significant amounts with almost no risk of anything being pulled back into their estates after the deferral period is over.

J.L. Pierson, ASA is an experienced business appraiser covering the tri-state area from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $250 million, as well as owners of family limited partnerships and professional corporations. He specializes in business valuation for estate/gift tax, succession planning, and litigation such as shareholder disputes and divorce, corporate development and other transactional support purposes.

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