Changes, [good] changes everywhere !

Many changes, it would appear as of the frigid first months of 2014, are afoot in the business valuation industry. First, Morningstar, the parent of Ibbotson since 2005, decided not to publish its SBBI 2014 Valuation Edition, which many appraisers have for decades relied upon for key inputs into the cost of capital. Instead of catering to the small BV business, Ibbotson decided to concentrate on stock brokers and mutual funds. The principal contribution of SBBI-Valuation was, ultimately, largely based on the unproven relationship between the discount rate attributable to public companies and that of private ones. Typically, the discount rate observed in the public company realm would be increased by both an industry premium and a size component premium. Ibbotson has in fact botched its annual lists of industry public participants, principally because many public companies do not operate only in one sector. The size premium it published was likely not very reliable, since it is not clear that an additive relationship exists between the cost of capital for public companies and that of their private brethren.

Duff & Phelps stepped into the void, and promised it would publish, in connection with its annual cost of capital study, all data previously sold by Ibbotson; in fact it just issued a preview edition which is strictly comparable with SBBI-Valuation and includes the data to the end of 2013. Since its days within Standard & Poor's, D&P has published annual regression formulas linking various indiciae of size, such as revenues, net income, cash flow, book equity and total assets with the cost of capital for public companies. Many would say that D&P is a better method than the Ibbotson-based add-on method. D&P's offering is to be called the annual Valuation Handbook, and it is marketed in conjunction with an on-line calculator.

Finally, three independent BV practitioners took up the challenge of developing a discount rate calculator specifically for private firms by regressing the prices actually paid for 500 private firms during the past several years, the equivalent discount rate, and revenues. Based on revenues, it calculates the discount expected [as in "*Implicit* Private Company Pricing Line"] which can be adjusted for by the real tax rate paid. It would appear to be spot-on [i.e. agree with Duff & Phelps] for entities with revenues in the $2-10 million range. The best part is that the 3 authors make this available for free at their website, which means your BV appraiser does not need to charge you for any additional cost ! I can't wait for more information about IPCPL.

**Estate of Helen Richmond v. Commissioner**
**T.C. Memo 2014-26 filed February 11, 2014**

The case revolves around the Estate's ownership of a 23.4% interest in Pearson

Holding Co. ["PHC"], a Pennsylvania corporation founded in 1928 for the purpose of providing descendants of a Frederick Pearson with income primarily from dividends of large capitalization public companies. The Estate filed its return in 2005 and valued PHC using an income approach, correlated by transactions on the PHC stock during the 1990s, and earlier valuations performed for deceased shareholders. The accountant responsible for the estate valuation was a well-rounded professional with 20 years experience, but he was without BV training and had written a total of 20 business valuation reports. His draft report was never finalized, but it was attached to the Estate's return. The Estate later obtained a more formal report from an appraiser, who valued the Estate's interest at $5.0 million, while the IRS valued it at $7.3 million. The Service also wanted a 20% penalty for substantial valuation misstatement.

PHC's portfolio had a low turnover and, correspondingly, it had a Built-In Gain of $45.6 million, or almost as high as its net asset value of $52 million. C-corporations are liable for the BIG when the securities are sold. The Courts have previously split on how to calculate the discount necessary to reflect the BIG tax liability. Some federal circuits [5th and 11th] have allowed deduction of the entire tax liability, while others [2nd and 6th] have refused to assume immediate liquidation. The Court here accepted the Service's calculation of a 43% discount for BIG liability, despite being based on mutual funds' trading records, as a middle-of-the road approach.

It is generally believed the income approach to valuation is best used when valuing an operating business. Holding companies are generally valued at net asset value less discounts; PHC is a holding, and its stock portfolio can be valued from stock tables. The Court rejected the income approach in fairly uncertain terms.

Both parties used the closed-end funds trading record to support a lack-of-control discount and neither attempted to match the characteristics of the funds with those of PHC. In the end, the Court rejected some outlyers and took an average of the remaining funds. The lack-of-marketability discount was supported by both sides from IPO and restricted stock studies, not surprisingly coming up with a low number [Service,] or high number [Estate.] The Court was unconvinced and took the average as its only real choice. Why are business valuation litigants not better prepared?

### From an ASA publication: Why Appraisers Do Not Sleep All That Well at Night

Several provisions of the Pension Protection Act of 2006 can induce headaches for appraisers, particularly as it requires that taxpayers document the value of donated property by obtaining a "qualified appraisal" in order to take a tax deduction. Oh, and PPA also provides that appraisers may now be subject to tax misstatement or gross-misstatement penalties. But the IRS is not an intended user as USPAP qualifies it; does that make a difference ? Not really, as PPA allows sanctions against the appraiser if "he or she knew, or reasonably should have known, that the appraisal would be used in connection with a return or a claim for refund." Additionally, IRC section 1.170A-13(c)(5)(I) requires that the appraiser's certification include a statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a penalty under §6695.

While there are still hagglings about what the term means, a “qualified appraisal” [1] is treated as a qualified appraisal under regulations or other guidance by the Secretary of the Treasury, and [2] is conducted by a qualified appraiser in accordance with *generally accepted appraisal standards* and any regulations or guidance of the Secretary. A “qualified appraiser” is an individual who [1] has earned an appraisal designation from a recognized professional appraisal organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary; and [2] regularly performs appraisals for which he/she receives compensation and [3] meets with such other requirements as may be prescribed by the Secretary in regulations or other guidance. Another section provides that an individual will not be treated as a qualified appraiser unless [1] he/she demonstrates verifiable education and experience in valuing the *type of property subject to the appraisal* and [2] he/she has not been prohibited from practicing before the IRS by the Secretary under §330( c ) of Title 31 of the Internal Revenue Code at any time during the 3-year period ending on the day of the appraisal. With respect to what constitutes generally accepted appraisal standards, the only guidance at this point is an Internal Revenue Bulletin which indicates that an appraisal consistent with the substance and principles of USPAP would qualify.

## WHY SHOULD I BOTHER VALUING MY BUSINESS ?

It is not uncommon to be asked by a business owner “Why should I bother with a business valuation?” Sometimes the question can be traced to concern over the cost of an appraisal, sometimes because of the time involved and sometimes because the business owner sees no purpose in the exercise. Why bother having the business valued when the plan is to pass the business on to the next generation anyway?

Here is a check list of reasons why you would want to have the business independently valued, perhaps giving you reasons to move the job higher up the list.

1. Someone else is going to value your business anyway: if you are seeking a business loan, the bank will have its own criteria for valuing the collateral value of the business. You may in such a case need to demonstrate a higher value. Similarly, whether you sell the business during your lifetime or leave it in your estate at death, the IRS may have an interest in valuing your business; in many of these cases, the value will be comparatively high because high values translate into high tax revenues.

2. You question a potential buyer’s valuation, particularly if it is higher than you expect. The real answer to “why” is complex. The higher number may induce the seller to provide exclusivity during the due-diligence period, or other reasons. The best protection against the buyer’s tendency to low-ball the seller is for the latter to have a firm grasp on the true value, as provided by a 3rd party appraiser.

3. Your retirement depends on it! Make sure to make the extra effort and hire an appraiser in order to insure your retirement is not compromised by a low offer.

4. It affect you estate plan. If there are other assets, and one child receives the business while the other[s] life insurance and other financial assets, a mechanism should be in place to make sure none of the children are short-changed as business values are subject to significant change over time.

5. The valuation is useful in planning for a key person. In order to provide effective incentives even if the key person will not become a successor business owner, only a valuation can provide the base line for deferred compensation arrangements such as phantom stock or stock appreciation rights.

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**J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business community 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 disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which appear to affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of an attorney.**

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