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The IRS publishes a Treatise on Adequate Compensation

The Service recently made public its "*Reasonable Compensation: Job Aid for IRS Valuation Professionals"* an information-heavy repository of facts and techniques on the subject and, perhaps, an indication of how it thinks about the issues. However, the job aid "is not an official pronouncement of law, and cannot be used, cited, or relied upon as such." The job aid includes a comprehensive list of valuation approaches, compensation data sources, suggested articles and court cases.

The reason for the controversy is simple. Taxpayers are responsible for deducting business expenses which are "reasonable," and higher compensation, particularly for the owners who file the corporate return, would equate to lower profitability and thus lower income taxation, everything else being equal. In fact, compensation paid may, in fact, represent a dividend, which is not deductible. There is another reason for the IRS's interest: if compensation is lower than reasonable, then the Service may not have collected the proper amount of FICA on the owners' salaries. Often such lower salaries are offset by higher profit distributions, which are not subject to employment taxes.

The bibliography is extensive, and could be construed as something of an IRS endorsement of the methodologies advocated by the authors. The job aid also includes questions to be asked by an agent when determining adequate compensation, as well as sample information document requests [IDR.]

The market approach is often used when litigating the reasonable compensation issue, in effect comparing the subject's employee salaries with what the market will bear for the same skills and responsibilities. It is based on the so-called "Independent Investor Test." While less commonly applied, the cost approach is also advocated.

Factors to be considered include: the employee's role in the company; external comparison of his/her salary with those paid by similar companies for similar services; character and financial condition of the company; conflict of interest in relationship of the employee to the corporation and internal consistency in the corporation's treatment of payments to employees. All-in-all, a fine resource in litigation.

The IPCPL Cost of Capital Model

A new methodology has now been introduced to support the cost of capital applicable to small business. Based on monthly-updated regression analysis of the Pratt's Stats database of sold businesses up to $10 million in revenues [along with the smaller public companies,] the new method was compiled by 3 business appraisers, and theoretical background is now available. No attempt has been made to monetize the

data, which this appraiser finds refreshing. All the user has to do is to enter the subject's revenues and out pops the recommended equity rate. Extensive tools are available to support and generally tweak the model.

This firm has been using the Implied Private Company Pricing Line for a few quarters, and its returned cost of capital has been relatively close to those returned by the Duff & Phelps analysis, presenting a now classic, comprehensive and well documented approach. In fact, several recent appraisals of $3-8 million revenues firms done by this firm have concluded that a composite of IPCPL and Duff & Phelps was the most reasonable determination of the applicable cost of capital.

What happened to Ibbotson and its build-up method, or CAPM until recently considered the obvious ways to go? Both have been found to be plagued by too many serious issues: its industry risk add-on is still not entirely reliable, and the size add-on is largely a convention of many years. At the base of the problem with CAPM is whether the cost of capital for private companies has anything to do with the cost of capital of larger, publicly-traded firms. We think it does not, and thus we are reluctant to use the Ibbotson build-up method any longer. Finally, under CAPM, the beta remained largely undefined.

IRS Minority S-Corporation Job Aid now available

On October 29, 2014, the IRS published *The IRS Valuation of Non-Controlling Interests in Business Entities Electing to be Treated as S Corporations for Federal Tax Purposes*[1]*.* It reviews the requirements of Revenue Ruling 59-60 and the tax characteristics of the S status, while stressing the nature of the property interest for sale.

Clearly, this job aid can not be expected to willingly recommend any form of tax affecting, since it would conflict with the Service's goal to maximize income tax collections. However, a somewhat more nuansed picture emerges, and the following factors are listed as needing to be carefully reviewed in each case:

1. Size and composition of the pool of potential buyers;
2. The economic interests of hypothetical sellers, including rights under the constituting documents;
3. The actual revenues and expenses available to the S corporation;
4. The availability at the entity level of equity and debt capital;
5. The likely holding period of the transferred interest.

The job aid offers 2 examples, one being based on the facts and circumstances of the subject of the Gross decision; the other - based on a expected long life of the election leading to a higher discount hurdle rate and a higher Lack-of-Marketability Discount, also suggest no tax affecting but an obviously lower value. Using experience and analyzing all relevant facts and circumstances has never been out of fashion, and

[1] It carries the following margin "this job aid is not Official position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position."

the job aid does little to suggest otherwise. At the same time, the job aid offers little new guidance to the practitioner.

Damage Calculations

This is the second article on a series on Lost Profits and Damage Calculations; it is inspired by a lecture by a fellow practitioner which I found particularly relevant. The first article appeared in the December, 2014 issue.

The testimony by expert witnesses is governed by the Federal Rule of Evidence 702, and most states follow similar rules. It requires that “a witness who is qualified by knowledge, skills, experience, training and education ..may testify if [a] the expert’s scientific, technical and other specialized knowledge will help the trier of facts to understand the evidence and determine the fact at issue; [b] the testimony is based on sufficient facts or data; [c] the testimony is the product of reliable principles and methods; and [d] the expert has correctly applied the principles and methods to the facts of the case.”

Federal Rule of Civil Procedure 25 (a) (2) (B) states that “the expert witness must prepare a report including the following: a complete statement of all opinions the witness will express and the basis and reasons for them; the facts or data considered by the witness in forming them; any exhibits that will be used to summarize or support them; the witness’s qualifications, including all publications authored during the previous ten years; a list of all other cases in which, during the previous 4 years, the witness testified as an expert at trial or by deposition, and a statement of the compensation to be paid for the study and testimony in the case.”

The *Frye Standard* [Frye vs. United States 293 F 1013 D.C. Circuit 1923] states that “the thing from which a deduction is made must be sufficiently established to have gained general acceptance in the field.” The *Daubert Standard* [based on 3 federal cases in 1993-1999] uses the following factors [a] whether the theory or technique in question can be and has been tested [b] whether it has been subjected to peer review and publication [c] its known or potential error rate [d] the existence and maintenance of standards controlling its operation and [e] whether it has attracted widespread acceptance within a relevant scientific community. The standard in Connecticut can be found in the CT Code of Evidence § 7-2 applying Daubert, while New York’s can be found at N.Y.C.P.L.R. § 4515 applying Frye.

The *AICPA Code of Professional Conduct* [sections 1,100, 1,200 and 1,300;] the *ACFE Code of Professional Standards* and the *ASA Principles of Appraisal Practice* and *Code of Ethics* are among the relevant standards.

Wrongful acts leading to damages include: breach of contracts, employment discrimination, theft of intellectual property and trade secrets. Damages generally consists of lost profits, lost wages, unjust enrichment, un-reasonable royalties, diminution of business value, out-of-pocket costs or ill-gotten gains. Lost profits are calculated either [a] “but for” sales less actual sales = Lost Sales. Lost Sales - Avoided

costs/expenses = lost profits or [b] “but for” sales - Estimated costs/expenses = “but for” Profits; Actual sales - Actual costs/expenses = Actual profits; “but for” Profits - Actual profits = Lost Profits.

Proximate Cause: The harm done by the defendant does not continue indefinitely; the harm suffered by the plaintiff may be attributable to others besides the defendant; the expert must consider and account for intervening causes of loss. The law does not require that damages be mathematically certain, but that they are “capable of measurement based on known and reliable factors without speculation.” In order to allow the recovery of damages, it must be established that the consequences of the wrongful act on the plaintiff were reasonable foreseeable by the defendant. The plaintiff has the Duty to Mitigate under the “doctrine of avoidable consequences:” This includes taking reasonable steps to mitigate damages. A 3rd article will appear in the Fall issue.

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. **©J.L. Pierson & Co. LLC 2015**

J.L. PIERSON, ASA
368 Heights Road # 2392
Darien, CT 06820

http://www.NYNJCT-BV.COM
(203) 325-2703

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(203) 325-2703 (203) 434-4648