JIM HITCHNER'S VALUATION PRODUCTS AND SERVICES

Q&A

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A free Q & A periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

Email your question to: jhitchner@valuationproducts.com

INTEREST-BEARING DEBT IN A DISSENTING SHAREHOLDER ACTION

Question 1: In determining fair value in a dissenting shareholder action, when is it appropriate to modify the amount of interest-bearing debt in a company's capital structure?

***Answer 1*:** In dissenting shareholder cases, Delaware law provides that a company be valued as it is being operated and generally rejects adjustments for changes that might be made by a different management. Therefore, Delaware Court of Chancery has consistently used the actual capital structure at the valuation date, rather than a hypothetical capital structure based on industry norms.(*See, e.g., In Re Radiology Associates* at 493; *MedPointe Healthcare* at *67 "While [petitioner's expert] may well be correct than an 80/20 capital structure would be typical for a company of this nature, Carter-Wallace's traditional aversion to debt could be expected to continue.")

Citations supporting this position include, among others, In *Re Radiology Associates, Inc. Litigation*, 611 A.2d 485 (Del. Ch. 1991) at 493; *Hintmann v. Fred Weber, Inc.*, 1998 Del. Ch. LEXIS 26 (Feb. 17, 1998) at *18, *Cede & Co. v. Technicolor, Inc.*, 2003 Del. Ch. LEXIS 146 (Del Ch., Dec. 31, 2003) at *169; *Cede & Co. v. MedPointe Healthcare, Inc.*, 2004 Del. Ch. LEXIS 124 (Sept. 10, 2004) at *67, *Andaloro v. PFPC Worldwide, Inc.*, 2005 Del. Ch. LEXIS 125 (Aug. 19, 2005) at *54.

Many other states consider Delaware case law in corporate matters, including in dissenting shareholder cases. To the extent that a state's appraisal standard requires a company to be valued "as is," the existing capital structure should be used for appraisals. However, a U.S. District Court, applying Nevada law, did not use a company's actual capital structure in *Steiner Corp. v. Benninghoff*, 5 F.Supp.2d 1117 (D. Nev. 1998) at 1126. I view this case as an anomaly.

Answer by: Gilbert E. Matthews, CFA, Sutter Securities Incorporated (San Francisco). gil@suttersf.com

S CORPS AND TAXES

Question 2: Opposing valuation expert (divorce case) has calculated an ongoing cash flow from a Sub S entity pursuant to the income approach. He then calculated the federal tax and [State] income tax avoided on "cash flow available for dividends." He added the [state] and federal tax avoided together, divided this by the capitalization rate and added this estimated benefit to the operating value for the entity determined under the income approach. Are you familiar with and can you explain this adjustment?

Answer 2: Without knowing how "cash flow for dividends" has been defined by the opposing expert, I'm presuming it is the same as net cash flow to equity for an S corporation (not a C corporation), and it does not recognize the income tax expense associated with S corporation operations. Also, I'm assuming that when the opposing expert adds "the [state] and federal tax avoided" to his valuation conclusion, he is adding the present value of avoided dividend taxes, not income taxes.

In Hitchner's *Financial Valuation Applications and Models, second edition* (pp. 569-620), there are a number of useful models that explain how to value S corporation ownership interests. While these models share many similarities, there are differences as well.

Because I'm most familiar with the Treharne model, I'm going to focus on it. As a quick summary of the model, first value the

Continued on next page

entity as if it was an otherwise equivalent C corporation. The C corporation value should then be adjusted for the present value of the *dividend* taxes avoided. Next, the equivalent C corp value should be adjusted for the present value of the differences between S corp *income* tax rates (i.e., the marginal personal rate appropriate for the most likely investor) and C corp *income* tax rates.

The present value of the avoided dividend tax can be determined by calculating the "excess distributions" paid. "Excess distributions" are not total distributions or, as I am speculating, the opposing analyst's "cash flow available for dividends." Instead, "excess distributions" are those distributions in excess of the equivalent C corp (not S corp) income tax liability (effectively, "excess distributions" are C corporation dividends).

If the opposing expert is assuming 100 percent of S corp net cash flow is distributed, he is ignoring that portion of S corp net cash flow going to the government to pay the personal tax liability associated with entity income. As is the case for a C corporation, tax payments do not create value for the shareholder (the shareholder is the conduit for S corp tax payments, and the company is the conduit for C corps; but in both cases, the tax payments do not contribute to shareholder value). As a result, the present value of the avoided dividend tax (currently 15 percent at the federal level plus the applicable state tax) only should be based on "excess distributions."

Some respected appraisers argue that the tax savings (to be clear, dividend tax *and* capital gain tax) can be based on 100 percent of the "excess cash flow" (as with "excess distributions," "excess cash flow" is cash flow in excess of the tax liability associated with entity income). Their argument is based on the S corp owner's ability to avoid future capital gains taxes because retained cash flow contributes to basis build-up, which decreases the capital gain tax liability at some future date of sale (this benefit is not available to C corps). Even so, one knowledgeable colleague goes out of his way to emphasize that the preceding is only true in today's tax environment, because long-term capital gains taxes are equal to dividend taxes at the federal level. When those tax rates change, the preceding simplified analysis must be modified to reflect the greater complexity associated with the rate differences between capital gain and dividend taxes.

Another key assumption associated with the preceding analysis is that investors are indifferent between the avoidance of capital gain and dividend taxes because they occur on a simultaneous, annual basis. However, unlike dividend tax avoidance, the cash flow benefit associated with the capital gain tax avoidance does not occur annually. Instead, it occurs at a future uncertain date. If the taxable events do not occur simultaneously, the present-value conclusion will overstate value. Furthermore, if the timing of the taxable event cannot be identified with reasonable certainty, the analyst's assumed timing will be adding precision without adding accuracy.

More specifically, in the typical small company (i.e., one which has an equity discount rate in the 20 percent range or greater) that has a capital gain taxable event in year ten, the present value of each $1.00 of capital gain avoided is $0.16 ($1.00 ÷ [1 + 20 percent]^{10}]), and the present value of the avoided dividend tax at a 15 percent rate is only $0.02 (15 percent x $0.16). If a probability factor associated with the event occurring in year ten is considered, the value is even less. Obviously, the contribution to value associated with the avoidance of capital gain taxes is speculative and, for the typical small business (as a rough rule, those companies with market capitalizations in Ibbotson's 10th decile) it represents less than 2 percent of the present value of net income (net income is the basis for basis build-up, not net cash flow) for a holding period of at least 10 years.

The astute analyst also will recognize that the benefit decreases as the level of distributions increases (i.e., less income will be retained and the capital gain tax associated with the basis build-up will be smaller). Logically, if the only distributions made each year are for the tax liability associated with S corp income, the retained portion of each $1.00 of S corp net income will be only $0.60 (assuming a 40 percent tax distribution). Hence, only 60 percent of each $1.00 of S corp net income will contribute to the basis build up. Obviously, 60 percent of $0.02 (see preceding paragraph) is only $0.01 or 1 percent of the S corp present value.

In summary, when valuing an S corporation ownership interest, we determine the equivalent C corporation value (which infers the income stream is tax affected at C corporation income tax rates), and then adjust it for the present value of:

1. the avoided *dividend* taxes on future "excess distributions" (with the latter being derived from a percentage of historical pretax income, historical gross cash flow or the management's expectations multiplied by future earnings or cash flow, and then subtracting the equivalent C corp income taxes for each period),
2. the differences between each future period's *income* taxes associated with the equivalent C corp and the subject S corp.

A possible third adjustment for the capital gain tax avoidance is always considered, but typically is dismissed if the company is small and the timing of the future taxable event is at least 10 years out.

Answer by: Chris D. Treharne, ASA, MCBA, BVAL, President of Gibraltar Business Appraisals, Inc. in Longmont, CO ctreharne@4avalue.com

Continued on next page

FAIR MARKET VALUE WITH COMPULSION TO SELL?

Question 3: We are valuing 50 percent of a profitable, established construction company ($5 million revenue), owned equally by two family members (A and B), for gifting purposes. A and B are the only officers of the company.

A was caught in a bribery sting while bidding for a job and was convicted. Based on the advice of his attorney, A wants to gift his ownership to B in order not to affect the company's status in bidding for future jobs. A would continue working for the company after the gift.

How would you adjust value for the "willing seller being under compulsion to sell?"

Answer 3: We will assume based on the facts, that A is gifting the interest to B without any cash changing hands. Given that A is gifting his interest to B, Section 25.2512-1 of the Internal Revenue Code Gift Tax Regulations provides important guidance and requirements for this engagement. Under these regulations, "fair market value" of the gifted interest is the appropriate standard of value. And since one of the criteria for fair market value is that no compulsion exists, the valuator would determine the value of the gifted interest as if there were no compulsion. By determining the value without regard to compulsion and determining a true fair market value, this transaction would be viewed as arm's length even though it was between related parties. It would be much more likely to pass the "sniff test" with the IRS, so there would seem to be no need to adjust the value for compulsion unless the parties didn't want to comply with the IRC.

If for some reason there were still a need to determine "willing seller being under compulsion to sell," it would be a daunting task to determine the value. This "standard of value" would seem to be similar to investment value, namely the value to a particular seller. In order to determine investment value, the analyst would need to consider the specific facts and circumstances of the transaction, the seller's *motives* as well as his or her *motivation,* the amount of time (or lack of it) allowed for the transaction, whether or not the terms were arm's length, and a whole host of other factors, many of them qualitative.

Perhaps a bigger issue is the future financial impact that the bribery conviction will have on the performance of the company. It's likely that the company's reputation will suffer and that the company will lose jobs that it might otherwise have won. In some respects, the likely diminution in the value of the company due to the principal's legal troubles could represent the "compulsion to sell discount."

Answer by: Kevin R. Yeanoplos, CPA/ABV/CFF, ASA, the Director of Valuation Services for Brueggeman and Johnson Yeanoplos, P.C. in Tucson, Arizona kry@bjyvalue.com