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EXPERT ADVICE

Intangible Asset Valuations: Spot These Common Errors Before Going into Court

When reviewing your expert's intangible asset valuation—or the opposing party's—it's critical to identify the most common errors that can cause a court to discredit or even disregard a report. The following checklist serves as a quick guide to avoid the most obvious deficiencies:

- *Is the standard of value followed?* Has the analyst carefully disclosed and defined the applicable standard of value? Has the standard of value been followed consistently throughout?

- *Are all three valuation methods considered?* These include the income, market, and asset approaches.
- *Is the internal analysis consistent?* For example:
 - Did the analyst match pricing multiples or capitalization rates to the wrong economic income measure?
 - Are current intangible asset operational data matched to different time periods, without appropriate adjustment?
 - Did the analyst "normalize" financial statements without also normalizing the corresponding data for selected comparable companies?
 - Was a "highest and best use" analysis performed?
 - Was an "actual use" analysis also performed?
 - Did the analyst make extraordinary, subjective, or speculative assumptions?
- *Is there sufficient support for selected variables?* Any analyst should document the data used, the procedures performed, and the valuation conclusions reached. There should also be sufficient tracing from the data in the quantitative analysis to the intangible asset in the owner/operator financial statement.
- *Do the numbers add up?* Mathematical errors are more common than anyone cares to admit; check all numerical calculations for accuracy, and make sure rounding conventions are consistent.
- *Does the analyst rely too heavily on 'rules of thumb'?* These serve only as a "sanity check," not as a basis from which to derive substantial intangible asset valuations.
- *Is there sufficient data and research?* The analyst should have conducted all relevant research, clearly threading the data into the quantitative analysis and valuation conclusions.
- *Is there adequate due diligence?* The analyst should have reviewed all relevant contracts and corporate documentation, including internal financial statements and external marketing statements. Sales, licenses, contingent liabilities, and litigation should have also been considered.

Tax Court Declines to Tax-Affect S Corp In Gift Transfer Case

Dallas v. Comm’r of Internal Revenue, 2006 U.S. App. LEXIS 216 (September 28, 2006)

The *Dallas* case bears enough factual resemblance to *Gross v. Commissioner* (originally decided by the Tax Court in 1999, confirmed by the 6th Circuit in 2001), to alert most appraisers and attorneys of the issues as well as the outcome—which adds yet another tax-affecting and discount case to the IRS arsenal.

When a sale is not a sale

In the Dallas family, the father “sold” about 55% of non-voting stock in a private S Corporation to his sons’ trusts, in exchange for cash and self-canceling notes. At the time, a third party appraiser ascertained the fair market value of the stock using a capitalization of income approach, discounted by a 40% tax-affected rate, 15% for lack of control and 35% for lack of marketability.

In auditing one of the sons, the IRS deemed the transfers to be gifts, to which it applied lesser discounts and no tax-affected rate; it also determined that the notes held less than face value because they were self-canceling. On review, the Tax Court quickly agreed that the inter-family transfers were “bargain gifts.”

The facts look fairly Gross

Four out of the five factors that bolstered the IRS position in the *Gross* case were largely present in *Dallas*:

1. The S Corp had stable and profitable operations;
2. The S Corp consistently paid out enough dividends for shareholders to pay their pro-rata, “pass-through” income tax (that the company also used retained earnings to expand its business did not persuade the court to distinguish *Gross*);
3. There was no evidence that the company’s corporate status would change; and
4. A minority interest was at stake.

The fifth factor in *Gross*—restrictive agreements that made it difficult to break the S Corp status—is not present in *Dallas*.

Court finds appraisal evidence weak

The taxpayer’s case also suffered when its second appraiser apparently lifted passages “verbatim” from the original appraisal and appeared to be “substantially

unfamiliar” with his own report. “We give [his] testimony little weight,” the Court said.

The original appraisal, which valued the S Corp shares at the transfer, didn’t fare much better. In providing his reasons for tax-affecting, the appraiser testified that: (1) he had always tax-affected; (2) an informal poll at (an unnamed) conference suggested that 90% to 95% of attendees tax-affected; (3) the ASA [American Society of Appraisers] rejected certification unless applicants tax-affected; (4) bankers, investment bankers, and business brokers tax-affect S Corp sales; and (5) his company had tax-affected ESOP valuations for the U.S. Department of Labor.

The Tax Court found this analysis “unconvincing.” Likewise, the taxpayer failed to persuade the Court to adopt the Delaware Chancery’s tax-affecting rationale in the recent *Delaware Open MRI Radiology Assoc., Inc. v. Kessler* (April 26, 2006), because the standard in that case was fair value. The fair market value standard, however, must consider the price a willing hypothetical buyer and seller would negotiate—and in this case, the Court found “insufficient evidence” that the hypothetical parties would tax-affect the S Corp’s earnings.

Discounts summarily dispatched

The Tax Court also quickly resolved the disputes on discounts:

1. *Lack of voting power.* The taxpayer’s second appraiser had specifically valued a non-voting minority interest and so did not apply a lack of control discount. He did apply a 5% discount for lack of voting power, as non-voting stockholders couldn’t pool their votes as minority shareholders might. In denying the discount, the Court said that any anticipation of pooling votes was “speculative.”
2. *Minority interest.* The taxpayer didn’t dispute the 15% minority discount for non-operating assets; however, it argued that the IRS’s 20% minority discount for operating assets was too low, because it used a formula based on the control premium, adjusting for excessive executive compensation. But the Court found no indication of this basis and no reason to increase the discount.
3. *Lack of marketability.* The taxpayer had examined restricted stock studies over several time periods, selecting the 34.2% mean marketability discount from pre-1990 studies and adjusting this to 40% to account for the company’s weak prospects of going public. But the Court ratified the 20% discount by the IRS,

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saying the taxpayer should have used studies from the time period in which the transfers took place—in which the median discount was 13.2% (suggesting, perhaps, that the marketability discount could have been even lower).

4. *Fair market value of the notes.* The taxpayer had executed the self-canceling notes in 1999; after learning from an IRS reviewer that these provisions reduced the notes' face value, the taxpayer deleted them from like notes in a 2000 stock transfer. The taxpayer claimed at trial that the 1999 notes had been a "drafting mistake," but the Tax Court held the "unambiguous," self-canceling notes to the lesser face value.

In the final analysis, the Tax Court's holding in *Dallas* remains internally consistent, if not consistent with *Gross*; whether either is "correct" on tax-affecting is still open to debate.

COURT CASE ABSTRACT

Classic Case of Expert v. Expert Won by Attention to Intangibles, Discounts

***Keener v. Keener*, 2006 Iowa App. LEXIS 659 (June 28, 2006)**

The Keener couple got married the day after incorporating their business, Alpha International, Inc., a toy manufacturer and seller. Over the next ten years, the husband acted as "the primary management force" and the wife was the sole shareholder, her consent required for all financial decisions. The toy company flourished, acquiring manufacturing equipment as well as sale rights to several notable toy brands. When they divorced in 2002, the wife received the business in her apportionment of the estate, apparently without notable disagreement. But the valuation of the company came down to a "classic battle of the expert witnesses," according to the appeals court, with a several million dollar disparity in their competing reports.

Wife's expert ignores intangibles

The wife's expert issued an initial report valuing the company at \$9.035 million. He used an asset approach, including a 15% discount for lack of marketability (DLOM) of the closely held corporation. He valued the company as a going concern, assuming that it would

remain in operation, but he assigned zero value to the intangible assets (intellectual property rights, etc.), because, according to his testimony, they produced no positive cash flow.

Six months after his original report, this same expert reduced the valuation by \$0.937 million, to account for possible litigation to defend against infringement of intellectual property rights in one of the major toy lines. He reduced the value further by the sum of \$2.89 million "to book" a contingent liability (another lawsuit where a settlement was pending, but no final agreement had been reached). Due to the perceived high level of litigation risks, he also increased the DLOM from 15% to 30%, for a final amended valuation of \$4.750 million.

Husband's expert reads the footnotes

However, a footnote in the wife's expert's initial report stated that management viewed the pending litigation as "ordinary routine matters incidental to the normal business...not expected to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows." Accordingly, the husband's expert argued that the wife's 30% discount was excessive. The better approach, he said, was to reduce the overall value by 5% to 10% and book the contingent and speculative liabilities. His net asset valuation of the company came to approximately \$10.170 million.

The husband's expert also disagreed with the zero valuation of the intangibles in light of the company's recent sale of two name brands for \$7.7 million and the pending (post-divorce) sale of a third brand for another \$7 million. Although he had not received the relevant financial documentation and so could not issue a firm opinion, the expert estimated the rights to "hundreds" of other brand names would add another \$20 to \$30 million of intangible asset value, increasing the company's overall net worth to the \$30 to \$40 million range.

Court agrees with valuing intangibles

The trial court wasn't persuaded by the wife's expert's valuation, in part for its failure to value the intangibles and also for its "speculative" discounts concerning marketability and contingent liabilities. It found the husband's expert's report more credible, adopting his net asset value of \$10.170 million and finding that the company's intangibles were worth an additional \$5 million. On review, the appeals court confirmed, finding that the "undisputed" evidence of name brand sales supported the intangible valuation.

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