Willamette Management Associates

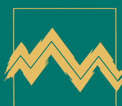
Insights

Issue 121

Summer 2019

Business Valuation, Forensic Analysis, and Financial Opinion Insights

Thought Leadership in Valuations for Estate and Gift Tax Planning, Compliance, and Controversies



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Insights

Insights, the thought leadership journal of applied microeconomics, is published on a quarterly basis, with periodic special interest issues. *Insights* is distributed to the friends and clients of Willamette Management Associates.

Insights is intended to provide a thought leadership forum for issues related to the Willamette Management Associates business valuation, forensic analysis, and financial opinion services.

Insights is not intended to provide legal, accounting, or taxation advice. Appropriate professional advisers should be consulted with regard to such matters. Due to the wide range of the topics presented herein, the *Insights* thought leadership discussions are intended to be general in nature. These discussions are not intended to address the specific facts and circumstances of any particular client situation.

The views and opinions presented in *Insights* are those of the individual authors. They are not necessarily the positions of Willamette Management Associates or its employees.

We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

Annual subscriptions to *Insights* are available at $40. Single copies of current issues are $10. Single copies of back issues are $250. The cumulative collection of the 1991–2016 issues of *Insights* are $2,500. Single reprints of current articles authored by Willamette Management Associates analysts are complimentary. Single reprints of noncurrent articles authored by Willamette Management Associates analysts are available at $100.

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Editor for This Issue: Weston C. Kirk

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Forethoughts

As our firm celebrates its 50th anniversary, we thank each of our clients, colleagues, and friends for their trust, loyalty, and support over the last half century.

This *Insights* issue celebrates 50 years of thought leadership in the trust and estate discipline. The discussions presented in this *Insights* issue are intended to provide high net worth families, attorneys, estate planners, and wealth advisers with an understanding of current topics related to the trust and estate profession.

Business and security valuations are often needed when families transfer wealth to the next generation. These wealth transfers may include private businesses, publicly traded securities, family limited partnerships, limited liability companies, bonds or other debt instruments, and intellectual property assets. The valuation of these business interests can be an important part of an estate planning strategy.

Willamette Management Associates analysts routinely value business interests and intellectual property for gift tax, estate tax, and generation-skipping transfer tax purposes. Willamette Management Associates analysts are experienced in developing complex taxation-related valuations and in defending such valuations through audit support and testifying expert services.

This *Insights* issue provides perspectives from the valuation profession, the legal community, and family business owners.

We are pleased to include a discussion from the matriarch of the Perdue family, Mrs. Mitzi Perdue. Mrs. Perdue shares estate planning (and life) lessons learned from her father, Mr. Ernest Henderson, a founder of Sheraton Hotels, and her late husband, Mr. Frank Perdue of Perdue Farms Inc.

This *Insights* issue includes thought leadership discussions on the complexities of valuing investments in art funds, measuring damages in breach of fiduciary duty litigation, and valuing a guaranty among related parties.

This *Insights* issue summarizes the recent judicial decision in *Kress v. United States*. Some observers conclude that this gift tax case provides guidance related to the valuation of the noncontrolling shares of an S corporation.

Other discussions in this *Insights* issue explore current topics regarding domestic and international taxation under the Tax Cuts and Jobs Act.

About the Editor

Weston C. Kirk

Weston Kirk is a vice president with Willamette Management Associates in the firm's Atlanta office. He works predominately in the firm's wealth management valuation services practice. His practice includes business valuation, economic damages analysis, and financial opinion services.

Weston works with the firm's national and international ultra-high-net-worth clients in the areas of federal income, gift, estate, and generation-skipping transfer tax; international tax; tax controversy and litigation; and various other intrafamily wealth transfer planning matters.

He performs business valuation and economic analyses for transaction pricing and structuring, taxation planning and compliance, employee stock ownership plan transactions and financing, securities offerings, litigation-expert-related testimony, and strategic information and planning.

Weston holds a bachelor of business administration degree in finance (with honors) from the Georgia State University J. Mack Robinson College of Business. He also holds a certification in economics from the Georgia State University Andrew Young School of Policy Studies.

He holds the certified valuation analyst ("CVA") designation of the National Association of Certified Valuators and Analysts. He is a member of the Balser Symposium advisory committee.

Weston recently provided insights on a panel discussion at the 2018 American Bar Association tax meeting. He is also a regular sponsor attendee of the Heckerling Institute and of the American College of Trust and Estate Counsel.

Why You Should Eat a Live Frog Every Day

Mitzi Perdue

This business leadership case study provides perspectives on the success of two iconic American companies: the Sheraton Hotels & Resorts chain and Perdue Farms Inc. In particular, this case study focuses on the personal and professional principles of two business leaders involved in the successful development of these two companies.

Introduction

This story begins when my father, Ernest Henderson, started the Sheraton Hotels. His brother, his roommate from college, and he pooled their war bonuses from serving in World War I and used the $1,000 to form the Sheraton corporation. Sheraton employed 20,000 people at the time of my father's death.

This story also involves my late husband, Frank Perdue. Frank started in the chicken industry with his father. At the time of his death in 2005, Perdue Farms employed 20,000 people and sold poultry and grain in more than 50 countries.

To achieve this kind of success, Henderson and Perdue regularly followed three principles. These principles played an important role in their success, and these principles are memorialized in this discussion.

The first principle is described next.

Eat a Live Frog Every Day

"Eating a Live Frog" is a metaphor for doing the tough things and doing them without delay. The idea comes from Mark Twain, who pointed out that if your job requires you to eat a live frog every day, eat that frog the first thing you do and get it over with. And if your job requires you to eat two live frogs every day, eat the bigger one first.

The thing is, people who are winners do the hard things first. They do not procrastinate, and they do not spend their time "sharpening pencils." They just plunge in and do what needs to be done, even when it is really, really hard.

Both men made a career out of doing the difficult things. In fact, both my father and Frank Perdue had to eat a large colony of live frogs during their lives.

The story of their entire careers was that, over and over again, they had to transform themselves to learn the skills that they needed. These were tough, difficult skills, ones that were not congenial or natural. However, if they had not learned these skills, they would not have achieved the success they did.

One of the first tasks that both men had to accomplish is: they were both, to the end of their days, abnormally shy people. To have a career in the public, they needed to transcend their shyness.

Ernest Henderson started out being pathologically shy. He either had Asperger's or was close to it. I know this from observing him. I also know it because an objective test he took showed just how shy and diffident he was.

When my father was in his late 20s, he could not figure out what he wanted to do with his life. He would try one thing and then another, and nothing seemed like an answer.

In fact, changing from one thing to another was so characteristic of him that when he and my mother got engaged, Grandmother Henderson took my mother aside for an important conversation. It was 1923 and they were sitting in the parlor of the family home in Cambridge, Massachusetts.

"Don't marry Ernest," Grandma Berta warned my mother, "He'll never stick to anything and you'll end up poor!"

My father clearly knew he had a problem. He recognized that he had a big live frog to eat. The year he got married, he did something that feels like an act out of desperation on his part. He went to the phonebook to find a career guidance counselor and found the Johnson O'Conner Aptitude Testing Service.

He made an appointment and arrived at the Beacon Street office in Boston's Back Bay. To help my father understand why he could not stick to anything, and to help him assess what kind of work he was suited for, Johnson O'Conner asked my father a battery of questions.

One of these was word associations. I no longer remember the words my father told me about, but I clearly remember the gist of how it was supposed to go. Let's suppose it was you taking the test back then. It would proceed something like this:

Counselor: "Tell me the first word that comes into your head when I say the word 'red.'"

You: "Blue."

Counselor: "Hot!"

You: "Cold."

Counselor: "Inside!"

You: "Outside."

These responses would be normal, but my father's responses to these association questions seemed to come from a different planet. The word "red" would make him think of a fingernail. "Hot" made him think of a windowpane. "Inside" made him think of a box of crayons.

At the end of a hundred or so of these word associations, the guidance counselor warned him that the kind of person who had such unusual associations with words would have great difficulty communicating with others or even understanding them. He told my father that he was such an extreme that, in O'Connor's entire career, he had never come across an individual who had such completely subjective, as opposed to objective, responses.

As my father told the story, O'Connor recommended to my father that he was best suited to working in a laboratory, by himself, where he would not have to interact with other people.

However, my dear father did not become a scientist. He ended up the polar opposite of a lonely scientist in a laboratory. Instead, he became one of the industry leaders in the hospitality industry. In his career, he was a genial host to so many people all over the world, that I think only a national politician would regularly interact with so many people.

So, the big question here is, how did my father, who was innately a shy, socially inept person make it in the hospitality industry?

He studied what he needed to learn to be a gracious host! He took the Dale Carnegie course and he read and re-read *How to Win Friends and Influence People*. He told me he would re-read it at least every 10 years.

He used his scientific bent (he had a degree from MIT in electrical engineering) to study what made people agreeable and nice to be around. He also took several public speaking courses, figuring that knowing how to communicate was essential for the career path he had chosen.

In the end, his greatest weakness—relating to people—became one of his greatest strengths. He got there by doing the difficult things, by each day working on transforming himself.

Interestingly, my husband Frank Perdue had an almost identical experience. You may know of him as a marketing icon, someone who was so successful at branding a commodity that he changed the whole profession of sales and marketing. And yet, in the early 1940s, he was so shy that when his father wanted him to sell feed grain, Frank could not look a prospect in the eye. Instead, Frank would shuffle from foot to foot, while staring at his field boots.

Like my father, Frank fought against his shyness so successfully that I suspect few people would guess it. However, I have several reasons for knowing that this is true.

First, I often heard him talk about his shyness. Next, I also observed it myself countless times. Finally, and perhaps most objectively convincing, I saw the results of a personality test that he once took that confirmed it.

The personality test came about because a university researcher, possibly from the Perdue School of Business, wanted to uncover some of the personality traits that made Frank a success. Since Frank was not known for introspection, I was surprised when Frank agreed to take the test.

It was 1995, and we each sat at the oak dining room table in our family room, and spent an hour with our separate tests, answering the forced choice questions with our pencils. The test, by the way, resembled the Meyers-Briggs test, but it was not actually associated with Meyers-Briggs.

Frank did not enjoy it, but he gamely went through each question, methodically marking off the answers and being a good sport about it. Since we were both taking it, I was as curious as can be as to what the results would reveal.

When the results came back, I saw that of the 25 or so parameters that were tested, Frank and I had similar scores. They showed what percentile we scored with regard to various characteristics such as honesty, punctuality, conscientiousness, perseverance, and so on.

Frank's scores were invariably higher than mine. But my scores always went up and down the same way that his scores did. If you had made a graph of our scores, the patterns, if not the actual scores, were identical. Except there was one glaring exception to all this—an area in which we were extreme opposites.

It had to do with what does and does not energize a person. The questions revealed whether you are energized by social interaction, or on the contrary, do social interactions "cost" you. In other words, does socializing require significant effort on your part?

My score in this dimension was in the top 5 percent. Frank's score was in the bottom 5 percent.

I get totally energized by interacting with people. In a large party, or if I am speaking in front of a large audience, I am in my element. I have the infinitely enjoyable feeling of "This is what I was born for!" Socializing is about as natural and essential to me as breathing. In fact, Frank used to say about me, with perfect accuracy, that I would rather give a speech than eat. I think all this came from being raised in the hospitality industry.

Frank's personality was the opposite of this. As an only child raised on a farm in the country, socializing did not "come natural," to use an Eastern Shore expression. For him, even to the end of his days, socializing was something that (even though he enjoyed it), drained him.

And yet he deliberately fought against this deficiency. He transcended himself. He became more than he was born with.

The thing is, Frank could see the importance of social skills and simply made himself not only learn them, but practice them. In the end, he perfected them. Today, I think almost anyone would agree that Frank Perdue became world class at just about every aspect of socializing.

But remember, he did not start out like that. Remember, he was the guy who, in a sales situation, could only awkwardly stare at his feet.

Like my father, Frank took the Dale Carnegie course. He simply made a study of how to become more outgoing.

For example, when he was first asked by the advertising company's copywriter, Ed McCabe, to appear in the chicken ads, Frank's first answer was, "No! Don't even think about it. I've never even been in a school play."

However, McCabe convinced him that he had to. McCabe told him, "Whatever you say about your chickens, your competitors can copy you! The one thing they can't copy is, you look like a chicken, and your voice reminds people of a chicken. You are the one part they can't copy."

Frank did not want to be in the ads, but he was also charmingly self-aware and knew that he looked like a chicken and sounded like a chicken and that he squawked a lot. He had no trouble joking about this, and McCabe was able to convince Frank that Frank's "chicken-ness" was an advertising advantage.

But now came a great big live frog for Frank to deal with. How does an extremely shy person convert himself into a television pitchman?

Frank spent weeks and weeks going over his 90-second lines. I would be surprised if he did not practice his 90 seconds of lines at least several thousand times. He would practice them in front of his family at the breakfast table and after dinner. And there would be hours spent in the living room, saying the lines over and over again in front of his daughters.

When the day arrived for the shoot, he made his way to the local park in Salisbury, Maryland, with its quaint white bridge in the background. He sat down at a tan-colored picnic tablecloth, held a chicken drumstick in his hand, and proceeded to tell Ed McCabe, "I don't want to do it! I can't do it! I can't even remember the lines!"

In other words, it was uncomfortable as anything in the world for this shy, introverted man to be staring at the video camera, mounted on its tripod, with the videographer counting down with his fingers, “Five! Four! Three! Two! One! Rolling!”

Live frog time for Frank!

Still, he forced himself to deliver his lines, “A chicken is what it eats! And my chickens eat better than people do! I store my own grain, fix my own feed . . . if you want to eat as well as my chickens, you’ll just have to eat my chickens!”

And then a funny thing happened: he had practiced his lines so often and knew the material so well that when he looked into the camera, he was not just reciting lines. Rather, he was looking into the camera, speaking from the heart about what he knew to be true.

If you watch the Frank Perdue videos—and you can find them on YouTube—you will hear a sincerity to his voice, a from-the-heart truthfulness in his tone, and cadence. Watching the ad, you would see and feel this. He was utterly, utterly believable.

Viewers felt this. In the end, this unusually shy man became a sensation on TV. His advertising campaign, “It takes a tough man to make a tender chicken” became the iconic ad of the 1980s, and it catapulted his company from a small, regional organization to the top tier of all chicken companies.

His willingness to advertise a commodity did not just change the chicken industry; it had an impact on countless other commodities as well.

However, keep in mind that he did it by transcending his limitations.

Which brings me to another part of Frank’s limitations, one that also involved eating still more colonies of live frogs. Frank had learned how to “give” to the camera and to come across as likeable and believable on TV. But there was an additional handicap to overcome.

If he was to be a spokesperson for his brand—and by the way, he was the first major CEO ever to do this—he would need to learn how to overcome the handicap of being socially shy and awkward. He practiced learning how to overcome this drawback, using an almost Olympic level focus.

Like my father, Frank read books, sought advice, and, as I have mentioned before, not only read *How to Win Friends and Influence People*, he also took the Dale Carnegie Course. Like my father, Frank was forever working on cracking the code of how to get along with people.

Frank used to share with me some of his approaches to this.

“Don’t talk with people about our overseas trip or the fancy parties we’ve attended,” he would coach me. “Your goal is to make the other person feel important. Making people feel important is the goal, not impressing them with what you’ve done.”

My husband would also coach me on the value of being self-deprecating. “It’s much more attractive to make yourself less important,” he would say, “because it lays the ground for them to feel more important.”

Frank would also tell me, “People don’t care so much about who you are as about how you make them feel.” He understood the great psychiatrist Williams James, who said 100 years ago, “The deepest principal in human nature is the craving to feel appreciated.” Focusing on them instead of on oneself was key to having a positive social interaction.

The social skills Frank developed, and his understanding of human nature, seemed to me to be boundless. As an example, I used to watch in awe when I would see him at a large gathering of people, when, for example, we would be supporting a charity.

Imagine for a moment that you are accompanying him at, let’s say, a United Way function. (That, by the way, was a charity he adored.) For starters, if the event was to start at 6:00 pm, you and he would be there at 5:58 pm.

You would be standing inside the room, maybe 30 feet from the door. You and Frank are positioned there so you have a chance to have an interaction with everyone as they enter the room.

Typically, each contact would be brief, but you, in your role of observing Frank, would notice that in each case, as Frank greeted someone, he was looking this individual in the eye, shaking his or her hand, and for a moment, focusing his attention on the person so completely, enveloping the person in his caring so totally, that the individual was almost certainly feeling at that moment like the most important person in Frank’s world.

In truth, at that moment, that person was the most important person in Frank’s world.

A couple of hours later, at the end of an event, you and Frank have shaken hands with everyone in the room. And, you would be in the unique position to know that this did not happen by accident. Frank had planned it by positioning himself near the entrance.

Frank was so insightful, going about it this way. Remember, businessmen typically go to big important events for networking and to be seen supporting whatever cause they are there for. However, after they have invested the time and the money to be there, how many of them accomplish

their networking and visibility goals as thoughtfully and as efficiently as Frank did?

Frank had gone to the effort to learn how to accomplish his networking and visibility goals. He had not left it to chance.

Frank's social skills at events were always a bravura performance, and those skills weren't limited to big social events. I often meet people even today who remember a brief contact with Frank: a secretary in an office where Frank was visiting her boss and took the time to be pleasant and make her feel important; or a taxi driver who for the rest of his life remembered the pleasure of having Frank Perdue talk with him about the cab driver's work, family, and life; or a server at a restaurant who remembered Frank treating him with the dignity of an equal.

We have been talking about how both men continuously ate the live frog of overcoming extreme shyness in order to develop the social skills they needed for their work. But that is not the end of the live frogs that came their way.

The second principle each man followed is described next.

To Be an Innovator, Be an Informavore

Both men were extreme "informavores." That is a made-up word, and I think I made it up, but maybe others thought of it first. Just as carnivore consumes meat, an informavore consumes information.

By endlessly accumulating knowledge on amazingly different subjects, Henderson and Perdue were able to see connections that were invisible to others. They each attributed much of their success to being willing to see things in new ways. That, in its way, is also a live frog. That is because it takes a huge effort to see things with fresh eyes.

Where did their ability to be innovative come from? It came, at least in part, from being willing to go way out of their way to absorb new information. Both men were advocates of the notion that "one good idea can change your life."

I have a favorite story of the lengths my father would go. One day in the 1950s, he drove from Boston to a small town in upstate New Hampshire to hear a lecture on business. I knew it was a 10-hour round trip journey, traveling on crummy roads, and in those days the maps were not great. In other words, it took him a lot of effort.

I found out later that the people who attended the lecture, included the owner of a local gas station and a small-town grocery store. And, here was the president of a national hotel chain that employed nearly 20,000 people attending this meeting.

When he returned home, I noticed he was carrying a pad of notes, and he was smiling. I thought it was incongruous that he would put the effort into attending a lecture that, to his 12-year-old daughter, seemed inconsequential.

"Why did you go?" I asked him. "These are not the VIP people you could be hanging out with!" I will never forget his answer. He looked at me, and said in a serious voice, that I remember to this day, "If you can get one good idea, wherever you find it, it can change your life."

Although he was the founder and head of a New York Stock Exchange-listed company, one that was on its way to becoming a billion-dollar-a-year business, he was not above hanging out with mom and pop business owners. As he told me, this was because "having access to good ideas gives me a leg up on the competition!"

Frank matched my father when it comes to being an informavore. He was always reading. The topics that interested him were diverse. He knew enough about Empress Catherine the Great to have a lively discussion about her with the Librarian of Congress. He was fascinated about the construction of the Brooklyn Bridge. You would not believe how much

he knew about the race horse Sea Biscuit, or treasure hunting, or military history, or the latest John Grisham novel.

When a subject interested Frank, he would dive into it. I remember he read so much about Alexander Hamilton, that when we visited the Hamilton Museum on Nevis Island where Hamilton was born, something amazing happened. The docent, after maybe 10 minutes of showing us around, stopped telling Frank and me about Hamilton. Instead, as we walked through the exhibit, looking at the artifacts and posters, it turned out that Frank knew so much about each of them, that the docent spent the next hour asking Frank about Hamilton! It was as if she were the tourist and Frank the docent.

Frank was like that. His mind was crammed with extraordinary amounts of information.

Frank drew inspiration from reading, attending lectures, hanging out with other business persons, and generally doing exactly what my father did—he put himself in the way of getting good ideas.

In the case of both men, they went way out of their way to get good ideas.

The diet for an informavore is summarized below:

1. Read everything—it does not have to be disciplined reading; in fact, it is better if it is not, because you never know where you will find a good idea
2. Attend lectures every chance you get
3. Haunt the Internet
4. Take classes
5. Go to conventions
6. Join associations
7. Network with people, who can give you ideas
8. Set up Google alerts on a topic
9. Sign up for newsletters
10. Listen to podcasts
11. Join a Mastermind Group

The third principle is described next.

Be Active and Agile

Part of the philosophy of "eating a live frog" is procrastination is against the rules. If there is a live frog that needs eating, do it without delay!

Both my father and husband had a huge propensity for action. Action meant having tremendous agility. I remember one night in the very early 1950s, my father told my mother and my siblings over dinner, "We're getting into the credit card business!"

He told us that there was this new entity, Diner's Club, and it was issuing credit cards. Father reasoned, that with a national hotel chain and a database of tens of thousands of clients, Sheraton could rapidly get into this attractive new business.

He told us that night, "We thought about getting into it this morning, and we started working on it this afternoon!"

In fact, he and his business partner Bob Moore, rolled out the Sheraton Credit Card in a matter of weeks. "We can make decisions and put them into effect much faster than our competitors," my father told me when I asked him to tell me more about it. He went on to say that he was pretty sure it would take his competitors months, if not years, to make and implement such a decision.

This agility proved profitable. He and Moore created a large, fully functional credit card system. A few years later, Sheraton was able to sell that system to another credit card company for a fortune.

I got to learn more than you might expect about credit cards. My first job at the age 15 was as a file clerk for the Sheraton credit card division of my father's business. I and eight other file clerks sat in a small office with shoe-box-size containers filled with alphabetized credit cards.

There were thousands of boxes, and our job each day was to match credit cards with lists of people who had not paid their bills. In these cases, our job was to remove the cards and record the credit card number. People at the front desks of the hotels were given a list of the credit card numbers that were not credit worthy, and they were asked to reject those credit cards.

But we also knew who paid promptly and who spent a lot. The number on an individual's credit card was a special code, and certain numbers would reveal to the front desk people that they were dealing with someone who was a VIP. Other numbers would reveal such things as, "This person is a very, very important person because he or she is someone who can book conventions!"

I was impressed that my father could come up with, in such a short period of time, an elaborate plan for vetting credit cards. It meant that when they sold the credit card division, the cards had a lot of value. After a couple of years, we knew a lot about the spending habits and reliability of each card holder.

The credit card example was emblematic of his approach to business. He told me that being able to respond rapidly and with agility—either

to opportunities or to problems—gave him a huge advantage over competitors.

He also told me that part of his success came from being the first to introduce innovations. Some examples: he was the first to introduce air conditioning in a hotel chain; he was the first to have bathroom scales, and he was the first to introduce the pull-out strings you could use to hang your socks over the bathtub. He came up with that last idea because it was something he wanted for himself and figured out that others would want it also.

In the case of air conditioning back in the early 1950s, I asked why he went to the enormous expense of paying for this innovation. His answer was, he was sure that the demand for comfort would be available everywhere soon. That meant, at some point, he would have to pay for it to remain competitive.

However, there is a lot of advertising and word-of-mouth value to being first. So, if you are going to have to spend the same money either way, why not be the first and get the benefit from it? After all, you do not win a lot of points by advertising, "Look at us! We were third to introduce air conditioning!"

His attitude was that doing 90 percent of what is required is one of the biggest wastes. This is because you have nothing to show for all your efforts. Doing 110 percent of what is expected (which I take to be the equivalent of eating a live frog), is one of the smartest investments. This is because for just a little more effort, it can pay off with a great reputation and more clients.

Frank Perdue was equally someone who loved action. I mentioned above that he pioneered advertising as a commodity. But he was also a pioneer in bird genetics (breeding a broader-breasted chicken) and in transportation (in order to ensure on-time deliveries, he went into the trucking business and today we are one of the largest trucking and transportation companies).

Since he wanted to control the quality of feed for his chickens, he got into the grain business. Today, roughly half of the income of Perdue Farms comes from grain and oilseeds.

Chickens eat the soybean meal, but there is 300 million pounds of soybean oil not used by Perdue Farms for raising chickens. Some of the innovative ways the oil is used include Little Debbie snacks, Frito Lay chips, and Stauffer cookies.

In explaining his approach of being both innovative and action-oriented, Frank loved to quote the story of an old sea captain who told his son, "My competition copies everything I do, but they can't copy my mind and I leave 'em huffing and puffing a mile and a half behind."

For Frank, the agility that resulted from research and development and the ability to put ideas into action were the magic keys to leaving competitors "huffing and puffing a mile and a half behind."

"Doing 110 percent of what is expected . . . is one of the smartest investments."

Both men had a huge propensity to action. They might be willing to put immense amounts of research and study into something, but they weren't afraid to commit and "pull the trigger." Their careers were characterized by *action*.

Putting It All Together

My father and Frank started out as shy men with zero experience in big business. My grandfather was an academic. And Frank's father's background was small-scale farming. To prosper, my father and Frank needed to grow not just horizontally in the skill sets they used, but also vertically, where they transformed themselves from shy, introverted young men to people who were comfortable on an international stage.

They did this by transforming themselves. They were each unusually shy men who learned to become charismatic public figures. They did the hard things.

They did it by becoming informavores. Because of broad interests and a huge databank of experience and knowledge, they were able to put together ideas and see opportunities that were invisible to others.

They did it by being agile. They made a habit of putting ideas into effect far more rapidly than their competitors. They loved action.

These techniques are available to you and to the people you advise. Encourage people to be brave enough to transcend their limitations, to explore the broadest range of interests, and to have a propensity for action.

This, of course, takes effort and it means doing uncongenial things. It means a diet of eating live frogs.

Mitzi Perdue is a professional public speaker, business owner, and author of the book, How to Make Your Family Business Last. *Contact her at Mitzi@MitziPerdue.com or visit her website at www.MitziPerdue.com.*

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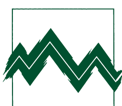

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Thought Leadership Discussion

Valuation for the Expatriation Tax—"So Long, It's Been Good to Know Yuh"

Curtis R. Kimball

Expatriation involves the relinquishment of citizenship or the termination of long-term residency in your home country. When this event occurs, the home country, especially the United States, may levy a tax on the expatriating party. The current expatriation tax in the United States is a tax on the built-in accumulated unrealized gain on an expatriate's worldwide assets. Business and property valuations are often required to document the expatriating party's exit tax position. In addition, such valuations may be required to assist in establishing a new tax basis in the new country. This discussion summarizes the U.S. expatriation tax and related valuation matters for the expatriate.

Introduction

When an individual U.S. citizen or a foreign long-term resident (i.e., a non-citizen long-term U.S. lawful permanent resident, also known as a "green card holder") decides to give up the status of a citizen or a green card holder, he or she becomes "expatriates."

This act of giving up the citizen/resident status is known as "expatriation." This also means that the expatriated individual ceases to be a U.S. taxpayer.

But before an expatriate can sing, "So long, it's been good to know yuh,"[1] there is a final reckoning with the U.S. tax authorities.

When this status-changing event occurs, the U.S. levies a tax, one more time, on the expatriating party by taxing his or her worldwide assets. This expatriation tax (also called an "exit tax" or, more generally, an "emigration tax") and the related valuation issues are the subjects of this discussion.

This discussion does not address corporate expatriations (also known as "inversions") or corporate tax issues concerning offshore assets under the Tax Cuts and Jobs Act of 2017.

Origins of the Expatriation Tax in the United States

Although other countries also have an emigration tax,[2] the U.S. is one of the very few countries in the world that taxes its citizens on their worldwide income and assets. Most other countries follow a "residence-based" tax system for individuals. That system allows a country's citizens to be taxed under the tax laws of the country in which they reside or source their income.

However, the only way a U.S. citizen (or green card holder) can exit the "worldwide" U.S. tax system is to renounce his or her citizenship (or end his or her U.S. long-term[3] resident status as a green card holder).

In the years immediately following World War II, the top marginal income tax rates were as high as 91 percent, later falling to 70 percent during the Kennedy and Johnson administrations. As a result, a number of wealthy, high-earning U.S. citizens relinquished their citizenship and moved to other countries with much lower tax rates.

This procedure was often accomplished by people shortly before retirement and just before the sale of their very valuable and highly appreciated investments, such as private companies.

Such an activity was seen as unpatriotic by Congress during the 1960s, as such gains were accrued using the privileges and protections afforded to citizens of the United States. However, the taxes on such accumulated gains would not be collected by the United States if the citizen expatriated.

The issue of expatriation received renewed attention as the new century began. Many more U.S. citizens have been living abroad since 1999.[4] In recent years, the number of U.S. nationals and long-term residents renouncing their citizenship or residence has also increased significantly.[5]

A prominent example was Eduardo Saverin, a co-founder of Facebook, who renounced his U.S. citizenship in September 2011 and thereby avoided an estimated $700 million in U.S. capital gains taxes.

The primary driver of more recent renunciations has been the financial difficulties that American taxpayers living abroad face in the wake of the U.S. Foreign Account Tax Compliance Act ("FATCA") regulations. This regime burdens U.S. taxpayers holding non-U.S. assets with extensive reporting requirements to the U.S. Internal Revenue Service (the "Service") and forces financial institutions with American clients to report to the Service as well.

Many foreign financial institutions will not do business with individual U.S. taxpayers or their controlled entities because of the complexities, uncertainties, and penalties under FATCA.

The first law to authorize exit taxation of tax-motivated expatriates was passed in 1966, creating Internal Revenue Code Section 877. Section 877 was amended in 1996 and again in 2004. The current law on expatriation taxation dates to June 17, 2008, when a new Section 877A was created under the Heroes Earnings Assistance and Relief Tax Act.

In essence, the current expatriation tax in effect since 2008 is a tax on the built-in accumulated unrealized gain on an expatriate's worldwide assets.

Who Is Liable for Paying the Expatriation Tax?

Although certain reporting requirements fall on all expatriates, the Section 877A exit tax rules apply to the following type of wealthier expatriates:

- Those with average annual net income tax payments in excess of $165,000[6] for the five years ending before their date of expatriation (i.e., the date of relinquishment of citizenship or date of termination of long-term residency)
- Those with a net worth of $2 million[7] or more on the date of expatriation
- Those who have failed to certify that they have complied with all U.S. federal tax obligations for the five years preceding the date of expatriation (including filing all required tax forms)

If any one of these three tests apply, then the person is considered a "covered expatriate." These covered expatriates face increased disclosures to the Service and have to calculate their expatriation tax.

Valuation Standards for Calculating Reported Asset Values

How to Decide What Assets Are Included for Expatriation Tax Issues

For purposes of the net worth test and the calculation of the expatriation tax, all assets include "any interests in property" that would be considered part of the covered expatriate's estate or taxable as a gift, if such death[8] or gift occurred as of the day before the expatriation date.[9]

This interest includes the right to use property, as well as the ownership of property.

There are two basic classifications of assets for expatriation tax issues.

The first category is "gains assets." These gains assets are the typical investment property (including private business interests) and other personal and real property owned by individuals that could be expected to grow in value while an expatriate was living in the United States. Taxpayers typically pay capital gains taxes when they sell such assets.

In addition to gains assets, the second asset classification category consists of three other groups[10] of assets subject to the expatriation tax rules. Therefore, these assets are also included as part of the $2 million net worth test and are recognized as exit tax income items, as follows:

- Deferred compensation items (e.g., pensions, annuities, deferred items of compensation—whether substantively vested or not)
- Specified tax deferred accounts (e.g., IRAs)
- Beneficiary interests in a nongrantor trust

Deferred compensation items come in two varieties: eligible and ineligible.

An eligible deferred compensation item is taxed when distributions are made to the expatriate and taxed on a withholding tax basis, as discussed further below.

An ineligible deferred compensation item is generally treated as if the expatriate received the account in a lump sum payment the day before the expatriation date.

Mark-to-Market Valuation Regime for Gains Assets

The value of each interest in property is determined on a "mark-to-market regime." As mentioned, these gains assets are deemed to have been sold or valued for transfer tax (i.e., gift and estate tax) purposes as of the day before the expatriation date.

Therefore, the standard of value used for calculating the expatriation tax starts (but doesn't end) with fair market value as defined under the Code and the regulations for estate and gift tax purposes. Fair market value in this context is defined as: "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[11]

The details of how to apply this standard are set forth in the regulations for determining gift and estate taxes.

However, the Service also indicates in Notice 2009-85 that certain valuation treatments allowed for estate and gift tax purposes should be altered or ignored for expatriation tax purposes. Favorable income tax treatment that might apply to certain types of assets are also altered or ignored. A number of examples of this changed valuation treatment are discussed further below.

One, the Service claims that fair market value should be determined as if the covered expatriate's interests were being transferred to family members, so that the discount-reducing provisions in Chapter 14, Sections 2701 through 2704, would apply.

Two, the exit tax rules do not allow the use of the alternate valuation date or the special use farm land valuation rules available for estate taxes.

Three, Section 121 allows a taxpayer a $250,000 exclusion on the sale of his personal residence. However, under the Section 877A expatriation tax, this favorable income tax provision is ignored in calculating the built-in gain on a residence.

As a result of these alterations, the standard of value used in expatriation tax matters is a modified fair market value standard.

Valuing the Second Classification Category of Assets

The "other groups" of interests under Section 877A(c) are valued in a similar fashion, using fair market value concepts under the gift and estate tax rules. Deferred compensation items such as pensions are typically valued on the basis of the present value of the estimated stream of accrued benefits as of the day before the expatriation date.[12]

Specified tax deferred accounts, such as IRAs, are valued based on their account balances. Beneficiary interests in nongrantor trusts are valued based on the expatriate's allocable share of the trust account's balance.[13]

Therefore, both of the last two groups use the modified fair market value standard discussed above, based on estate and gift tax valuation principles, since determination of account balances depends on the fair market values of the account's underlying asset values. A covered expatriate's interest in an insurance policy is valued under the gift tax regulations set forth in Regulation 25.2512-6.

Reporting and Justifying Fair Market Values

Form 8854 includes a balance sheet disclosure schedule that the covered expatriates have to fill out. All assets and liabilities are required to be listed "in U.S. dollars (at) the fair market value."[14]

The form is submitted "under penalties of perjury" and the covered expatriate declares that the schedules and statements submitted "to the best of my knowledge and belief (are) . . . true, correct, and complete."[15]

Covered expatriates must report values using “good faith estimates of values” but “formal appraisals are not required.”[16]

Because of the lack of regulations in this area, it is unclear whether the taxpayer has a duty of “adequate disclosure” as he or she does for transfer tax reporting purposes. Since the expatriation tax valuation rules are taken from transfer tax valuation regulations, it is reasonable to assume that adequate disclosure of the valuation positions taken would be necessary in order to ensure that an expatriation tax filing on Form 8854 was “true, correct, and complete.”

Furthermore, although Section 877A has been in existence for over 10 years now, the Service has never promulgated any regulations interpreting its valuation rules or other issues.[17]

Likewise, there are no court cases that substantively address valuation or other issues under Section 877A. The last court case to address any significant expatriation tax issues was decided in 1984.[18]

Even though formal appraisals are not required, they are useful for documenting the valuation reasoning and confirming that a value estimate was made in good faith and not by blind guesswork or by applying incorrect facts and analysis that amount to perjury.

In summary, the rules for the valuation of assets for the net worth test and for the calculation of the expatriation tax are a mash-up of both income tax principles and transfer tax principles and are not well supported by regulations, instructions, or court cases. These rules may appear simple at first glance, but actually they can be difficult to interpret and execute.

The Current Rules for Taxing Covered Expatriates

As of 2018, the expatriation tax is calculated in the following manner:[19]

1. Calculate the value of all of the covered expatriate’s worldwide net assets (there are some exceptions) and assume these gains assets were sold as of the day before the date of expatriation
2. Calculate the built-in gain (or loss) for each asset by subtracting the assets’ adjusted tax basis (there are some special rules on developing this basis for the expatriation tax)[20] from the value of the asset[21]
3. Subtract an “exclusion amount” of $713,000 (this amount is adjusted annually for inflation) as a deduction from the net built-in gains, allocating this amount pro rata among the assets with gains
4. Apply the appropriate tax rate (for capital gains, the top marginal rate is currently 23.8 percent) to the net gains left, if any, after the exclusion amount deduction

The exclusion only applies to gains assets. Therefore, the exclusion will not shelter income calculated on the acceleration of income recognition from deferred compensation items, specified tax-deferred accounts, and beneficial interests in nongrantor trusts—the other categories of assets discussed above.

These particular other groups of assets are either taxed when the covered expatriate receives distributions in a relevant future tax year[22] or included as income for the year in which the date of expatriation occurs.[23]

Withholding taxes of 30 percent are applied to future distributions. This typically applies to eligible deferred compensation items and beneficiary interests in nongrantor trusts. In other cases, however, the entire lump sum of an interest can be taxed immediately, particularly if a withholding tax notification[24] deadline is missed. Specified tax deferred accounts (like IRAs) and ineligible deferred compensation items are taxed as if received as a lump sum.

All expatriates are required to file Form 8854 with the Service. Covered expatriates must report to the Service their expatriation tax information on a section of Form 8854 and attach it to their annual income tax form (typically Form 1040) that they file to report and pay income (including expatriation) taxes for the year in which the date of expatriation occurs.

The covered expatriate can elect to defer the expatriation tax due for gains assets on a property-by-property basis until each asset is sold. But there are rigorous requirements to post security in the form of a bond or letter of credit to cover the tax owed and continuing requirements to file an annual Form 8854 in order for the Service to track that the expatriation taxes are eventually paid.

Interest at the underpayment rate (Section 6621) will also accrue on the deferred expatriation tax balance. It is rarely worth deferring payment due to the burdens of continuing compliance complexities and interest payments.

Valuation Planning for the Expatriation Tax

Valuation planning for minimizing the expatriation tax is based on the similar principles of minimizing transfer taxes through standard estate planning techniques.

First, individuals should consider fully utilizing their annual and lifetime transfer tax exemptions prior to expatriation in order to reduce their net worth. The individual exemption amount was $11.18 million for 2018 and is $11.40 million for 2019. This alone could reduce an affluent expatriate's net worth below the $2 million threshold to lawfully avoid becoming a covered expatriate.

Second, individuals anticipating expatriation should create fractionalized ownership interests in privately held businesses that are eligible for discounts for lack of control and for lack of marketability. Such ownership configurations can reduce net worth and lower the expatriation tax. However, this requires careful consideration of the Service's alteration of the fair market value rules applicable for estate and gift taxes as discussed previously.

Third, assets can be sold to relatives in exchange for notes at the applicable federal rate ("AFR"). The current AFR is typically below fair market value rates of interest. This allows notes to be discounted from their face value to lower fair market values for expatriation tax reporting purposes.

Some asset sales could also be considered before expatriation because of more favorable tax treatment under the regular income tax provisions of the Service, rather than subject them to exit tax treatment under Section 877A which can ignore some of these favorable provisions.

Other estate and gift planning techniques involving trusts and other transactions not directly involving valuation matters can also be useful.

Expert legal, accounting, and valuation advice is often necessary to avoid problems. Willamette Management Associates has been involved in developing valuation opinions for these expatriation valuation issues for planning and exit tax reporting compliance purposes, so feel free to consult with us.

Examples of Some Typical Client Situations

The Green Card Holder

Juan, a citizen of a South American country, has been operating his business interests in the United States for many years and obtained a green card while working for a U.S. public company early in his career. He is nearing retirement age and has interests back in his home country and elsewhere. These include a home country business co-owned with his brother.

He also owns interests in private equity companies and investments in hedge funds domiciled in Europe.

The Child Immigrant

Ivan was brought to America as a child and became a naturalized U.S. citizen. His parents were fleeing a tyrannical regime in his home country. He grew up in the United States, attended college here, and became a very successful businessman. Most of his investment interests and business activities have shifted to other countries as far away as in Asia. His parents still reside in the United States.

Because of a regime change and a resurgence in free markets and democracy in his homeland, he is considering expatriation back to his native land or to another country with a favorable tax and business climate.

The Birth Citizen

John was born in the United States. He is proficient with several languages and worked in many countries around the world. He met and married his wife in her native country while on a work project.

He is now active in businesses and investments on his own and with members of his wife's family in the region around her home country where they live. Because of continuing FATCA difficulties, he is considering expatriation to his wife's homeland. He and his siblings are also beneficiaries of a trust set up by his grandparents who are U.S. citizens.

Summary and Conclusion

Expatriation involves relinquishment of citizenship or termination of long-term residency in the U.S. As a result of this status-changing event, the U.S. levies a tax on the expatriating party's worldwide assets. The current expatriation tax is a tax on the built-in accumulated unrealized gain on an expatriate's worldwide assets.

The expatriation tax rules apply to certain wealthy covered expatriates, typically individuals with a net worth in excess of $2 million. These covered expatriates bear a greater expatriation tax reporting burden and will have to pay the exit tax if their net gains and resulting income items are in excess of the current exclusion amount of $713,000.

The assets and liabilities included in the exit tax calculation are valued on a mark-to-market regime. This regime is based on a modified version of the fair market value standard set forth in the transfer tax statutes and regulations (i.e., the valuation rules for gift and estate tax purposes).

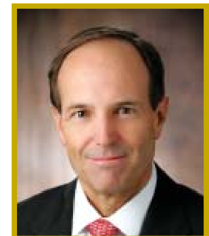
The rules for the valuation of assets for the net worth test and for the calculation of the expatriation tax are a mash-up of both income tax principles and transfer tax principles and are not well supported by regulations or court cases.

Although formal valuations are not required to support the taxpayer's valuation positions, they are useful in establishing that the estimated values were made in good faith and reported in a true, correct, and complete fashion.

Willamette Management Associates has been involved in developing valuation opinions for these valuation issues over many years for expatriation planning and exit tax reporting compliance purposes, so feel free to consult with us. We want you to be able to tell the Service: "so long, it's been good to know yuh!"

Notes:

1. The song "So Long, It's Been Good to Know Yuh" was written and recorded by Woody Guthrie on his album *Dust Bowl Ballads* (1935).
2. For example, Canada imposes a "departure tax" on parties who cease to be a tax resident in that country.
3. "Long-term" for expatriation tax purposes is defined as living as a lawful permanent resident in the United States at least 8 out the 15 taxable years prior to the expatriation date taxable year.
4. The U.S. State Department estimated that approximately 9 million nonmilitary Americans were living abroad in 2016, compared to only 4 million in 1999.
5. Prior to 2000, fewer than 1,000 people per year typically became expatriates. Since 2012, over 3,000 people per year relinquish their citizenship or green card status and expatriate, according to the Service.
6. This amount is adjusted annually for inflation. The amount shown is for 2018.
7. This amount is fixed and not adjusted for inflation.
8. Perhaps the expatriation tax is Uncle Sam's way of saying, as Don Vito Corleone might say: "You are dead to me."
9. IRS Notice 2009-85, also referencing Service Notice 97-19, 1997-1 C.B. 394.
10. As described in Section 877A(c).
11. 26 CFR Section 25.2512-1, concerning gift taxes.
12. Notice 2009-85, Section 5(D).
13. Notice 97-19, Section III.
14. Form 8854 (2018), page 5.
15. Ibid., 6.
16. Notice 97-19, Section III.
17. IRS Notices do not have the force and effect of regulations and are accorded no more weight than this discussion or any other expert's opinion.
18. See Furstenberg v. Commissioner, 83 T.C. 755 (1984).
19. www.IRS.gov/Form8854
20. Issues regarding the calculation of cost basis for expatriation taxes are beyond the intended scope of this discussion.
21. The deemed gain for each asset retains its original character: long-term capital gains, ordinary income gains, etc.
22. These are called "eligible deferred compensation items."
23. These are called "ineligible deferred compensation items."
24. Via Form W-8CE.



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GUIDE TO PROPERTY TAX VALUATION

Robert F. Reilly and Robert P. Schweihs

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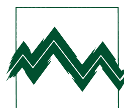

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Current Estate and Gift Tax Proposals in Congress

Parker F. Taylor, Esq., and Vanessa A. Woods, Esq.

The Internal Revenue Code has been a central focus of both taxpayers and tax advisers over the past two years. The recent 2017 Tax Cuts and Jobs Act ("TCJA") was the first major change to the Code since the Tax Reform Act of 1986. Many of the TCJA provisions benefit low- and middle-income taxpayers; however, the TCJA also provided tax benefits to high-income taxpayers. Some of these changes relate to estate and gift tax rates, exemptions, and exclusions. This discussion considers these salient provisions. Additionally, this discussion addresses current proposals in Congress that are intended to amend some of the TCJA benefits to high-income taxpayers. Although many of the proposals are targeted at curtailing the tax benefits provided to affluent taxpayers, some proposals attempt to redirect tax receipts from high-income and high-net-worth taxpayers to the middle class, infrastructure projects, and educational programs.

Introduction

The Tax Cuts and Jobs Act ("TCJA") was enacted into law on December 22, 2017. This landmark change to the Internal Revenue Code (the "Code") was particularly beneficial to wealthy taxpayers in the areas of estate tax and gift tax and reduced income tax burdens for some taxpayers, with the notable exception of certain higher earners in states with high state income taxes who saw their state and local tax deductions capped.

In recent months, various lawmakers—virtually all of whom opposed passage of the TCJA—have again suggested that the TCJA may be too generous to high-net-worth individuals and families.

Some lawmakers have suggested changes to the TCJA that would reverse certain aspects of the trust and estate tax statutes. Of these proposals, some are elaborate, while others are not yet fully developed. As issues of income inequality and the taxation of wealth continue to be debated, high-income and high-net-worth taxpayers should stay abreast of the current tax proposals in Congress.

This discussion summarizes the current TCJA and the current tax proposals in Congress as they relate to estate tax and gift tax matters.

Current TCJA Gift and Estate Tax Laws

Under the TCJA law, effective January 1, 2018, each person is granted an exemption of $11.18 million from payment of U.S. gift tax and, to the extent not applied toward gift tax, U.S. estate tax. This exemption effectively shelters the taxpayer up to an aggregate amount of $11.18 million in 2018, twice the amount that was applicable in the year before.

For each year after 2018, this exemption amount will be indexed to inflation. For tax year 2019, the exemption amount is now $11.4 million. For married couples, exemptions can be aggregated. In 2019, this amount is $22.8 million. The annual gift exclusion amount is set at $15,000 and is not adjusted annually for inflation.

Taxable transfers of any amount that exceed the exemption amount then in effect are subject to a transfer tax of 40 percent under the TCJA. This is the same tax rate as was in effect prior to the TCJA.

However, absent additional legislation, this new exemption level will terminate on December 31, 2025, and revert thereafter to the unified credit amount in effect prior to the enactment of the TCJA, or $5 million indexed for inflation after 2011.

Given the doubling of the gift and estate tax exemptions, as well as the lower income tax rate brackets, some legislators have criticized the taxpayer-friendly changes to the Code.

The following sections highlight the current proposals by members of Congress. Many of these proposals attempt to redirect tax savings to the middle class, infrastructure projects, and educational programs at the expense of high-net-worth taxpayers.

"Ultra-Millionaire Tax" Proposal

Elizabeth Warren is a Senator from Massachusetts. Senator Warren currently serves on the Senate Committee on Banking, Housing, and Urban Affairs; the Senate Committee on Health, Education, Labor, and Pensions; the Senate Committee on Armed Forces; and the Special Senate Committee on Aging. She is perhaps best known for her criticisms of Wall Street and the banking industry, and she was the leading advocate for the creation of the Consumer Financial Protection Bureau.

Recently, Senator Warren unveiled her tax plan entitled the "Ultra-Millionaire Tax."

Senator Warren's proposal would impose an additional tax on households with a net worth of $50 million or more.[1] These households (approximately 75,000 in total) constitute the wealthiest 0.1 percent of Americans.[2] Under Senator Warren's plan, these households would pay a 2 percent tax on every dollar of net worth in excess of the $50 million threshold, and a 1 percent surtax (i.e., 3 percent total) on every dollar of net worth above $1 billion.

No additional taxes would be imposed on the 99.9 percent of American households that do not reach the $50 million net worth threshold.

Economists estimate that Senator Warren's tax proposal would raise approximately $2.75 trillion in tax revenue over a 10-year period.[3] Senator Warren's plan also includes a 40 percent "exit tax" on the net worth above $50 million of any U.S. citizen who renounces their citizenship.[4]

Some legal scholars have questioned the constitutionality of Senator Warren's plan. Specifically, Article I of the Constitution has been interpreted to prohibit taxes directly tied to an individual's wealth, and some have suggested that the Ultra-Millionaire Tax would be a "radical expansion" of the federal government's taxing authority.[5]

On the other hand, Senator Warren's plan has received surprisingly widespread bipartisan support, with three online polls showing between 50 and 61 percent positive votes from both sides of the aisle.[6]

If implemented into law, it is likely that the Ultra-Millionaire Tax would be challenged in court, resulting in litigation that could take years to resolve.[7]

Beto O'Rourke, a former member of the House of Representatives who is currently running for president, has expressed support for Senator Warren's Ultra-Millionaire Tax plan and stated that he would tax ultra-wealthy individuals to generate revenue for the country's common benefit.[8]

In the past, Representative O'Rourke voted against repealing the federal estate and generation-skipping transfer taxes as well as reducing the top gift tax rate.[9]

More recently, he publicly opposed a bill to reduce individual income tax rates, noting that providing tax breaks to corporations and high-net-worth individuals would negatively affect the middle class.[10]

Top Marginal Tax Rate Revision Proposal

Alexandria Ocasio-Cortez is a first-term Member of the House of Representatives from New York. Representative Ocasio-Cortez is the youngest woman elected to Congress in United States history and is a relative newcomer to politics. Within weeks of being sworn in, she released an income tax proposal which made news headlines.[11]

Under the Representative Ocasio-Cortez proposal, an individual's income after the first $10 million of income would be taxed at a 70 percent rate. However, she has not yet elaborated on the proposed tax rates for income less than $10 million.

While the 70 percent marginal rate may seem high in comparison to the U.S. current income tax system (which has a maximum rate of about 37 percent for income in excess of $500,000), the U.S. has had similar tax rates in the not-so-distant past.

From 1957 through the 1970s, the highest marginal income tax rate was 70 percent or higher (topping out at a marginal income tax rate of 92 percent during President Eisenhower's time in office).[12]

While some have expressed concerns that such a significant increase in income tax rates would do harm to the economy, the years with higher marginal income tax rates were actually a time of economic growth.[13]

The Representative Ocasio-Cortez proposal has gained support from well-respected economists, 59 percent of registered voters, and fellow newcomer to the House of Representatives Ilhan Omar.[14]

In fact, the Representative Ocasio-Cortez proposal could net the U.S. government an additional $72 billion, or about 2 percent more, in revenue.[15]

"For the 99.8% Act" Proposal

Bernie Sanders is a Senator from Vermont, and he is the longest-serving Independent member in congressional history.[16] He released a comprehensive tax policy proposal in late January 2019 called the "For the 99.8% Act."

Senator Sanders's "For the 99.8% Act" tax plan includes decreasing the current federal estate tax exemption amount, currently $11.4 million per person in 2019, to $3.5 million per person (the federal estate tax exemption amount that was in effect in 2009). The plan also calls for raising the federal estate tax rate from 40 percent in 2019 to a progressive set of rates.[17]

The lowest proposed estate tax rate would be 45 percent on estates ranging in value from $3.5 million to $10 million, and the highest estate tax rate under the plan would be 77 percent on estates in excess of $1 billion in value.[18]

The lifetime gift tax exemption, currently $11.4 million per person, would be reduced to $1 million per person.

The "For the 99.8% Act" also proposes to:

1. eliminate the generation-skipping transfer tax exemption for any trust set up to last more than 50 years,
2. extend the required terms for grantor-retained annuity trusts to a minimum of 10 years, and
3. "sharply" limit the annual gift tax exclusion amount.[19]

Currently, the generation-skipping transfer tax exemption is available for dynasty trusts lasting in excess of 50 years, there is no minimum term for grantor retained annuity trusts, and the annual gift tax exclusion amount is $15,000 per donee per year.

Senator Sanders also intends to restrict valuation discounts on interests in family businesses and eliminate the so-called "loophole" which currently allows taxpayers to claim a lower value for an inherited asset for estate tax purposes than the value of the same asset that is claimed for income tax purposes to calculate the gain when the asset is sold.[20]

Finally, the proposed Act virtually eradicates the transfer tax benefits of installment sales to defective grantor trusts.[21]

Based on recent legislative history, it is uncertain whether some of the provisions in the "For the 99.8% Act" would successfully become law. For example, there have been recent attempts to reduce the federal estate tax exemption amount and to extend a mandatory term for grantor retained annuity trusts, but none of these attempts has been successful.[22]

In fact, currently, there are at least two bills before the House and one bill in the Senate that would completely repeal the federal estate tax.[23]

There is also a bill before the Senate that would reduce the maximum estate tax rate from 40 percent to 20 percent.[24] None of these bills has been passed into law either.

American Opportunity Accounts Proposal

Cory Booker is a Senator from New Jersey—the first African-American Senator from New Jersey—and previously served as the mayor of Newark, New Jersey. Senator Booker was a Rhodes Scholar and is a graduate of Yale Law School.

He introduced a bill to the Senate last fall called the "American Opportunity Accounts Act."[25] Under Senator Booker's plan, the Act would create a savings account for every American child upon birth. The child would not be able to access the funds in the account until he or she attained the age of 18 years, at which time the funds in the child's account could be used for things such as college tuition or a down payment on a home.[26]

The initial funding of the accounts ($1,000 for each child at birth and up to $2,000 per year depending on the child's family's income) would mainly come from increases in estate taxes and capital gains taxes.[27] Similar to Senator Sanders' tax proposal, under Senator Booker's plan, the federal estate tax exemption amount would be reduced to $3.5 million, and estates valued between $3.5 million and $10 million would be taxed at a rate of 45 percent (5 percent higher than the current flat 40 percent rate).[28]

For estates valued between $10 million and $55 million, the estate tax rate would be 55 percent, and for estates with values in excess of $50 million, the estate tax rate would be 65 percent.[29]

The American Opportunity Accounts Act also includes a minimum 10-year term for grantor-retained annuity trusts, reduces the annual gift tax exclusion amount to $10,000, and limits the annual gift tax exclusion gifts allowable for each donor to $50,000 (i.e., five donees).[30] The Act would increase the maximum capital gains tax rate from the current 20.0 percent to 24.2 percent.[31]

Middle Class Tax Cuts and Reforms Proposals

Other congressional leaders, including Senators Kamala Harris and Kirsten Gillibrand, have proposed changes to the TCJA to focus more on the middle class, while clawing back the additional exemptions provided to high-net-worth individuals under the TCJA.

Kamala Harris is a first-term Senator from California. She serves on the Senate Committee on the Budget, the Senate Committee on the Judiciary, the Senate Committee on Homeland Security and Governmental Affairs, and the Senate Select Committee on Intelligence. Senator Harris was previously Attorney General of California.

Last fall, Senator Harris proposed a nearly $3 trillion tax plan called "the LIFT the Middle Class Act." The plan centers on tax breaks for middle class and working class families.[32]

Under this plan, the federal government would provide tax credits that match each individual's earnings up to $3,000 ($6,000 for married couples).[33]

These credits would be phased out for those with higher earnings and would not be available at all to individuals who do not have income.[34] These credits would be funded by levying a new tax on large financial institutions and effectively repealing the TCJA of 2018.[35]

More recently, Senator Harris proposed a $315 billion increase in federal spending to provide public school teachers with significant raises.[36]

To offset the cost of this plan, which was released in mid-March 2019, Senator Harris is reported to be considering a proposal to lower the $11.4 million federal estate tax exemption amount and/or limiting tax-saving estate planning vehicles such as grantor retained annuity trusts.[37]

Kirsten Gillibrand is a Senator from New York, with a professional background as an attorney in New York City. Prior to her service as a senator, Senator Gillibrand was a Member of the House of Representatives from upstate New York.

In the past, Senator Gillibrand has supported increasing tax deductions for charitable giving, providing tax cuts to businesses that provide jobs, and expanding and improving the child care tax credit.[38] Senator Gillibrand also has introduced legislation to provide property tax relief to homeowners.[39]

Education and Infrastructure Reform Proposals

Amy Klobuchar has been a Senator from Minnesota since 2007, and she worked as a lawyer prior to her political career. Senator Klobuchar has proposed reforming and simplifying the tax code to close so-called "wasteful loopholes."[40]

In the past, Senator Klobuchar has voted against raising the federal estate tax exemption at least twice.[41]

Senator Klobuchar recently published a major policy proposal to fix the country's broken infrastructure. This proposal calls for repairs to dilap-

idated roads, improvements to facilities in public schools, the expansion of public transit, and the modernization of America's airports, seaports, and waterways.[42]

Under this plan, Senator Klobuchar proposes directing $650 billion of federal funding to pay for the repairs needed to improve our infrastructure. To cover the costs of these expansive refurbishments, Senator Klobuchar has suggested, among other fundraising plans, raising the corporate income tax rate from 21 percent to 25 percent.[43]

Summary and Conclusion

Whether for the benefit of the middle class, the infrastructure of the United States, or the education system of the country, legislators are contemplating means of taxation to support these initiatives from high-income and high-net-worth taxpayers.

Towards the end of 2012, when the estate tax exemption was scheduled to decrease from $5 million to $1 million, many wealthy individuals rushed to adjust their estate plan and make last minute gifts in order to take advantage of the higher exemption amount while it was still available. With potentially significant changes to the Code again on the horizon, it may be prudent for high-net-worth individuals to take precautions now, rather than adopt a wait-and-see approach.

It would behoove high-net-worth individuals to pay close attention to the tax policies being debated. In fact, there appears to be a significant focus on taxing high-net-worth individuals by increasing tax rates and surtaxes and reducing the available tax exemptions.

As is always the case when there is a potential change to the Code, individuals should review their current estate plans for any adjustments that may be necessary or beneficial to reduce potential tax liabilities and to take advantage of current tax loopholes that may be closed in the near future.

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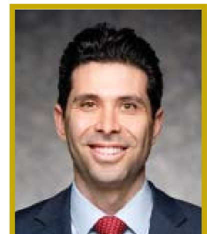

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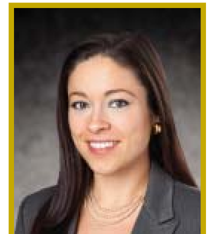

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Best Practices Discussion

Guaranty Fee Analysis for Intrafamily Promissory Notes

Weston C. Kirk

When one guarantees a transaction promissory note for another party—in practicality, "lending" the guarantor's creditworthiness to the obligor—does this guaranty arrangement provide the obligor with economic value? Does this guaranty create a gift tax reporting requirement for the guarantor? This discussion considers the elements of a transaction promissory note guaranty arrangement between family members (although the context can be extended to any two or more parties). This discussion also describes valuation principles to assist the analyst in quantifying the guaranty's economic value, either (1) in the form of a fee in exchange for the guaranty or (2) in the form of a gift from the guarantor to the obligor.

Background and History

A guaranty is a legal arrangement that provides assurance to answer for the payment of another's debt or duty. It is most frequently used to designate a private transaction in which one person, in order to obtain some trust, confidence, or credit from another, engages another party to be answerable to the lender of said trust, confidence, or credit in an instance of default. A guaranty may also designate a treaty through which claims, rights, or possessions are secured.

In this discussion, a guaranty is differentiated from the colloquial "personal guaranty" in that a guaranty is a legal concept and obligation that produces an economic effect. A personal guaranty, on the other hand, is often used to refer to a promise made by an individual which is supported by, or assured through, the word of that individual (and most commonly by that person's other assets).

The provider of the guaranty is called the "surety" or the "guarantor." The person to whom the guaranty is provided is the "guarantee," "creditor," or "obligee," while the person whose payment or performance is secured thereby is termed the "obligor," "the principal debtor," or simply, "the principal." In this scenario, the obligor would pay the guarantor to guaranty its debt with the obliged.

The *Merriam-Webster's Collegiate Dictionary* defines "guaranty" as an "undertaking to answer for the payment of a debt or the performance of a duty of another in case of the other's default or miscarriage . . . something given as security . . . the protection of a right afforded by legal provision."[1]

The *Funk & Wagnalls Standard Desk Dictionary* defines "guaranty" as a "pledge or promise to be responsible for the contract, debt, or duty of another person in case of his default . . . something given or taken as security."[2]

This discussion presents the salient attributes of intrafamily guaranty arrangements in the context of estate and gift tax transactions. And, this discussion outlines the analysis of intrafamily guaranty fees.

Intrafamily Promissory Notes

High net worth families often structure intrafamily borrowings with promissory notes to source needed liquidity for family members.

A loan and a promissory note are slightly different.

Loan agreements are evidenced by the signing of a loan agreement. A loan agreement is a contract between the lender and the borrower. It sets forth the terms and conditions of the loan and the rights and obligations of both parties.

By contrast, a promissory note is simply a written promise by the borrower to pay a stated amount of principal and interest until a maturity date.

A promissory note is also characterized as a negotiable instrument (as a check, which can be endorsed over to another party). Using a promissory note, instead of a loan agreement, benefits the lender in terms of liquidity. Because a promissory note can be transferred without the borrower's permission, unless the promissory note restricts a transfer, the lender can transfer ownership of the note.

Like most promissory notes, intrafamily promissory notes have a stated repayment of principal plus interest over a period (or on demand). The payments of both interest and principal can occur together or separately on a daily, weekly, monthly, quarterly, or annual basis; at maturity; or some variety thereof.

Although not always the case, most intrafamily notes have a stated interest rate of the applicable federal rate ("AFR").

AFRs are calculated based upon the "outstanding marketable obligations of the United States."[3] As such, AFRs are typically lower than the rates of interest commercially available to borrowers, even those with excellent credit.

When an original promissory note is issued at the prevailing AFR, the loan is deemed to have provided for adequate interest. Provided that the transfer is a bona fide sale for full and adequate consideration, a promissory note issued at the AFR does not bear a gift tax consequence because the note was not a below-market loan.[4]

Intrafamily Promissory Note Guaranties

Each guaranty arrangement is unique. Generally, no two guaranty arrangements are the same—time changes, the underlying assets change, the amounts change, and so on.

Most intrafamily guaranties tend to utilize a generic "rule of thumb" fee of 1 percent of the note principal being secured. This may be accurate in some cases, but not accurate in all cases. As guaranties on complex assets held by and financed among family members become more sophisticated and controversial, especially in the consideration of the Internal Revenue Service (the "Service"), perhaps these unique guaranty arrangements should be valued as part of the transaction process.

Some attorneys have indicated that the rise of intrafamily promissory note guaranties was spurred by the meeting notes of Martin M. Shenkman, Esq., of Shenkman Law, from the Heckerling Institute conference in 2017 during the afternoon session on sophisticated estate plans by presenters John W. Porter, Esq., of Baker Botts and S. Stacy Eastland of Goldman, Sachs & Co.

In the Shenkman notes, Mr. Shenkman suggests that for trusts established for the child, as beneficiary, to purchase limited partnership interests from parent for a note, the trust should, at least, have the ability to pay the note. Otherwise, there could be a concern that the parent had a deemed retained interest. Shenkman suggests that a general rule of thumb should be 10:1 debt to equity in the trust.

In lieu of a seed gift (or other assets held by the trust), Shenkman suggests that some practitioners may instead "seed" the trust by a guaranty, typically a guaranty of 10 percent of the note. Furthermore,

he adds that for a guaranty to provide substance to the transaction, there should be an ability for the guarantor to pay, and that a guaranty fee should be paid by the trust to the guarantor.[5]

Carrying forward this hypothetical example, a child's trust purchases limited partnership interests from the parent for a note. The lender (parent) may request that the borrower (child's trust) have "seed funding" of 10 percent of the value of the note. Perhaps, a grandparent can provide a guaranty to a parent for 10 percent of the note held by a child's trust during the note's existence.

When the borrower (child's trust) is unable to make principal and/or interest payments on the note (and all other avenues of repayment, including the liquidation of the limited partnership interests initially acquired), the guarantor (grandparent) would pay the lender (parent) up to 10 percent of the note principal amount.

For the guaranty to have any value, the trust would need to be creditworthy and the only way for the trust (in this case) to be creditworthy, assuming the trust has no other assets of significant value, is if the limited partnership interests generate annual distributions and capital appreciation during the holding period (or life of the note/guaranty).

During the holding period, if the limited partnership interests generate annual distributions and capital appreciation, then the seller will not need to exercise the guaranty.

If this financial arrangement provides the comfort the seller demands (i.e., a guaranty of the first default not to exceed 10 percent of the note initial principal), then the seller should require the trust to directly enter into the financial arrangement. Without creditworthiness better than the trusts, there is no reason for the grandfather to be involved in this guaranty.

The guaranty fee is often intended to cover the period through the maturity date of the underlying debt. However, guaranty fees can take all shapes and sizes.

For example, a guaranty could only be provided for a short period of time (and not the entire duration of the note). Alternatively, there could be two guarantors, wherein one guarantees the first portion of the default amount and another guarantor guarantees the second portion of the default amount.

An exhaustive list of elements that make each guaranty unique, and the factors that affect the fair market value (or economic value) of guaranty fees are as follows:

1. Note terms and conditions
2. Guaranty terms and conditions
3. Time of the guaranty (e.g., the maturity date of the note)
4. Amount of the guaranty
5. Stop loss of the guaranty (if any)
6. Terms of the guaranty agreement
7. Process of when the guarantor must pay
8. Ability for the guarantor to hedge the borrower's risk
9. Current value of borrower's assets/equity
10. Types of assets held as collateral under the note
11. Ability/expectation of future values of the assets held by the borrower
12. Ability of the borrower's assets to generate income (by virtue of distributions or liquidity events) for interest and principal payments
13. Volatility of the borrower's assets (current, prospective)—individually and collectively
14. Ability of the borrower to pay the note
15. Nature of payments (e.g., balloon note with one payment of principal and interest, or equal annual payments)
16. Prepayment plan (if any)
17. Timing of principal payments and interest accruement

Often there is a requirement of prior recourse against the borrower in guaranty arrangements. That is because the guaranty is often structured as a guaranty of collection—and not as a guaranty of payment.

The obligations of the guarantor are often further conditioned and contingent upon events taking place, such as the following:

1. The receipt by the guarantor of written notice from seller of seller's commencement of actions diligently to pursue collection of the obligations from the borrower
2. The seller's actual commencement of and diligent pursuit in good faith for remedies to collect the obligations under the note
3. The failure of seller to collect any part of the obligations being guaranteed after the attempt to collect
4. A detailed notice from seller to the guarantor of the amount of the obligations remaining outstanding after the attempt to collect

Furthermore, the guaranty fee agreement will often outline various covenants for the borrower and the guarantor to comply with. These covenants may include, but are not limited to, the following:

1. Buy and sell investment assets only in bona fide sales for full and adequate consideration
2. Not permit any material part of such guarantor's assets to be levied upon under any legal process
3. Not transfer all or any material part of such guarantor's assets (or, in the case of a guarantor that is a trust, not distribute any part of the principal of such trust) or engage in any other activity to the extent that such transfer (or distribution) or other activity would impair the ability of such guarantor to make any payment when due under the guaranty
4. Comply with all applicable federal, state, and local laws
5. Pay all taxes to the extent payable by such guarantor accruing after the date first set forth in the guaranty

Analysis of Intrafamily Guaranty Fees

In the example illustrated above, the child's trust will need to compensate the grandparent for the guaranty of up to 10 percent of the loan between the child's trust and the parent. Again, the parent (within the perspective of an arm's-length transaction) may (and in this hypothetical case will) require the child's trust to seek a guarantor for the loan used to acquire a limited partnership interests in the family limited partnership.

That is because, in this case, the child's trust has no other assets to act as collateral to the note principal and interest payments.

The analyst will be asked to value the guaranty fee to be paid by the child's trust to the grandparent in order for the grandparent to adopt the risk of potentially paying up to 10 percent of the note principal if the child's trust defaults. This 10 percent portion of the note principal being guaranteed is known as the "value at risk" or the "maximum guaranty amount."

Important considerations to understand when estimating the economic value of guaranty fees (oftentimes under the definition of fair market value) include the following:

1. Guarantors receive premiums to assume the value at risk if the borrower defaults on any of the payment obligations to the seller.
2. Guarantors maximum upside is the premium received from the borrower.
3. Guarantors are liable if the borrower defaults on any payment to the debtor at any time through the maturity date of the debt.
4. The borrower is in default if it is unable to timely make the annual interest payments at the stipulated interest rate or payment of the principal balance due, with any unpaid accrued interest, upon the note's maturity dates.
5. If the assets held by the borrower decrease in value below the note balance (with accrued interest), the guarantors may ultimately become liable for payments to the seller up to the maximum guaranty amount.

The analyst will consider which valuation methods under the three generally accepted property valuation approaches may be best to apply in the guaranty fee analysis. These three property valuation approaches are the market approach, the income approach, and the cost approach.

The market approach may be the best approach to apply in most guaranty fee analyses to estimate the value of the guaranty fee by virtue of applying a put option model.

In the hypothetical case illustration, the factors above most closely resemble the economic elements which are best captured by a put option arrangement modeled by applying an option pricing model ("OPM"). Additionally, the unique factors of an effective "stop loss" for the guarantor of 10 percent of the note principal, such as in the hypothetical case, may be measured by a bull put option spread OPM.

A bull put spread is an option trading strategy that assumes the underlying asset will go up moderately in the near future. The trader sells a put option in the money (receiving a premium) and buys a put option out of the money (paying a smaller premium). The strategy has a maximum profit of the net premium received less commissions paid (in this case, the fees paid to arrange the guaranty fees have already been borne by both parties and are excluded from consideration in this analysis).

The maximum profit is achieved when the price of the underlying asset closes at or above the strike price of the short put (the put purchased in the money).

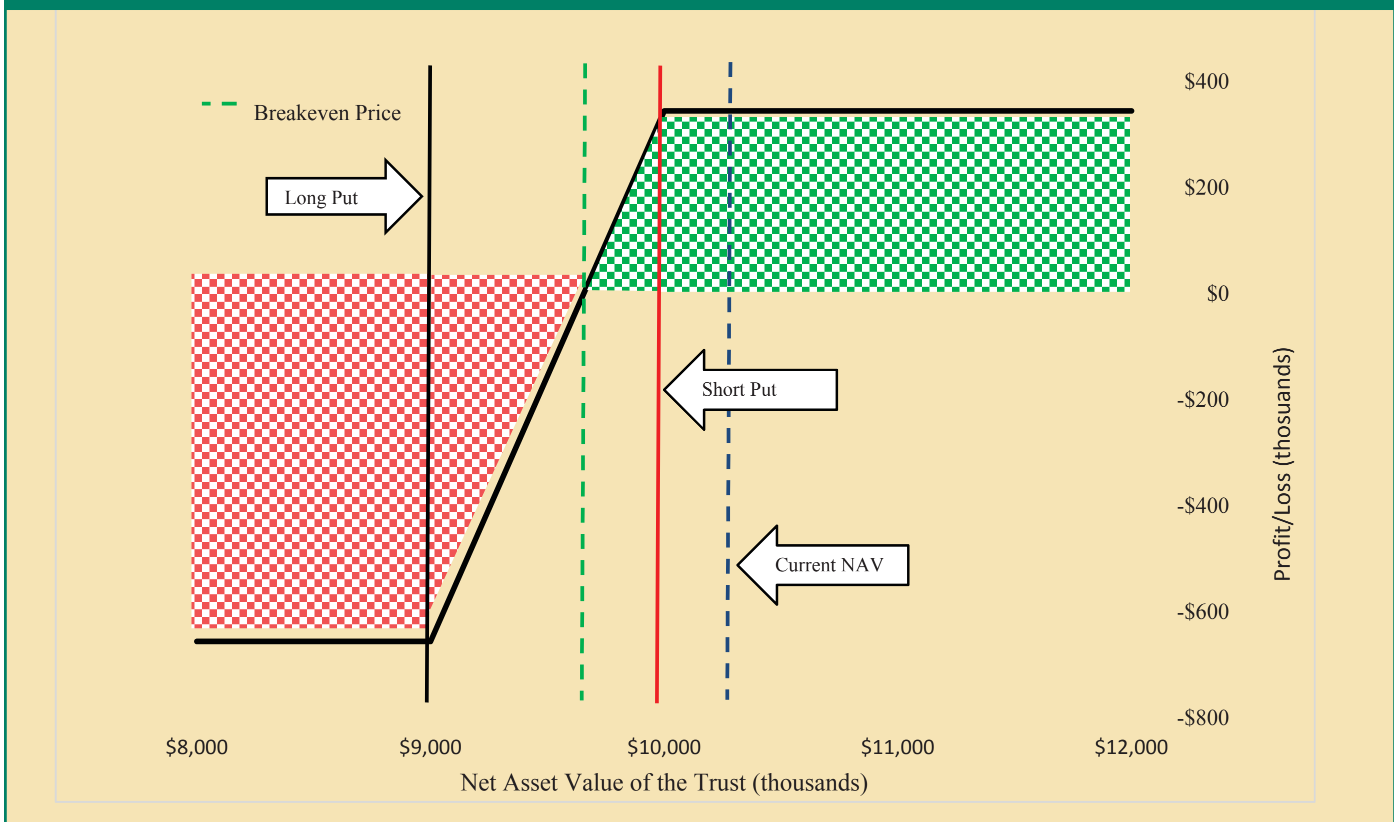
An example of a bull put spread profit or loss diagram is presented in Figure 1 in this discussion.[6]

An option is a financial derivative that represents a contract sold by one party (the option writer) to another party (the option holder). The contract offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset at an agreed-upon price (the strike price) during a certain period of time or on a specific date (exercise date).

A put option gives the option holder the right to sell a security at a certain price on or before the exercise date. In that way, the put option buyer (the option holder) expects the underlying security to decrease in value. If the security price decreases, the option buyer (who holds the option) will be able to buy the security at the market price (the lower price) and put the share to the option seller (the option writer) for the strike price (which is above the current market price).

The premium exchanged for this type of contract represents the maximum upside for the put option writer. The seller of this option is betting that the security does not fall below the strike price. To the put option buyer, the premium paid for this option is his or her maximum loss.

Figure 1
Profit and Loss of the Hypothetical Guaranty Fee Arrangement



If the market price does not decrease below the strike price during the time period of the option contract, the option is denoted as expiring worthless.

However, if the option is exercised while the security market price is below the strike price, the put option holder economically benefits from the price difference of the market price and the strike price, less the option premium paid for this right.

Options that are able to be exercised during the life of the option are denoted as American options. Options that can only be exercised at the exercise date are denoted as European options. In either case, the fee (or premium) that the parties to a put option agreement (or contract) agree to needs to be estimated.

The most widely used option premium pricing model applied to estimate the premium exchanged from the buyer (who is long the contract) to the seller (who is short the contract) is the Black-Scholes option pricing model ("BSOPM").

The basic BSOPM depends on five valuation variables. These variables are as follows:

1. The current price of the underlying asset (the spot price)
2. The exercise price of the option (the exercise price)
3. The length of time to the expiration of the option
4. The risk-free interest rate
5. The standard deviation of the annual rate of return on the underlying asset(s)

The BSOPM is expressed in two parts, by the call option value and the put option value, as follows:

$$\text{Call option value (C)} = S \times N(d_1) - Xe^{-rt} \times N(d_2)$$

$$\text{Put option value (P)} = Xe^{-rt} \times N(-d_2) - S \times N(-d_1)$$

where:

S = Stock price

X or E = Exercise (strike) price

$N(\ )$ = Value of cumulative normal distribution at the point ( )

d_1 = $\dfrac{ln(S/E) + (r + \sigma^2/2)^t}{\sigma\sqrt{t}}$

d_2 = $d_1 - \sigma\sqrt{t}$

ln = Natural logarithm

r = Short-term riskless rate (continuously compounded)

t = Time to expiration, in years

e = Base of natural logarithms

σ = Annual standard deviation of return (usually referred to as "volatility")

"The most widely used option premium pricing model applied to estimate the premium exchanged from the buyer . . . to the seller . . . is the Black-Scholes option pricing model. . . ."

In the hypothetical case example, the analyst could use the BSOPM to estimate the price of two theoretical put options that mirror the attributes of the guaranty arrangement in order to estimate the fair market value of the guaranty fee.

The first put option would have an exercise price at the value of the note ("Option 1") and second put option would have an exercise price 10 percent below the value of the note ("Option 2").

The difference in the prices of Option 1 and Option 2 is the fair market value of the guaranty fee.

That is because an investor assuming the same (or similar) risk of the guarantor would buy Option 1 and sell Option 2, thus locking in a maximum profit and minimizing his or her potential losses to the first 10 percent of the drop in the value of the underlying asset.

In applying the BSOPM to estimate the put value of Option 1 and Option 2, the analyst determines the following:

1. The expected volatility of the underlying asset portfolio held by the borrower
2. The time period of the guaranty fee
3. The risk-free rate during the duration of the guaranty
4. The dividend yield on the underlying assets held by the borrower (if any)[7]

The most complicated input (and the most material driver of the option values) is expected volatility. In most interfamily loan guaranty fee scenarios, the analyst will be dealing with private investment assets, so either a look-through approach (looking at the underlying assets of the private investment assets) or comparable approach (looking at guideline or comparable publicly traded volatile assets) is used.

Further, if the borrower has meaningful collateral to pledge, the value of that collateral should be analyzed, during the holding period, to analyze if

there is more or reduced risk regarding the creditworthiness of the borrower.

If the borrower has additional assets, say, positive equity in the trust, then the current price of the underlying assets used in the BSOPM formula makes the put options not at-the-money but out-of-the-money (i.e., lowering the value of the guaranty fee).

In analyzing the spread (or differential) between the cost to buy Option 1 for a premium and sell Option 2 for a premium, the cost of this bull put spread analyzes the probability that the guarantor payment of the value is at risk.

The difference in value between these two instruments (the net premium) of this position is the amount that represents the fair market value of the guaranty fee if paid by the borrower to the guarantor all at once on the effective date of the guaranty in order for the guarantor to assume the risk under the terms and obligations of the guaranty.

Illustrative Example

Exhibit 1 illustrates a hypothetical calculation of the guaranty fee derived by the use of the bull put spread BSOPM presented in this discussion.

Consistent with the hypothetical example used throughout this discussion, Figure 1 illustrates the same hypothetical guarantor potential profit or loss.

Exhibit 1 illustrates that the guarantor is willing to accept a guaranty fee of $345,000 to be liable for up to the first 10 percent of the $10 million note principal if default occurs (assuming the note accrues until maturity in year nine and that interest is paid annually or accrued therein). That is, the guarantor is willing to be compensated $345,000 to be potentially liable to the seller for up to $1 million under the guaranty arrangement. This amount is predicated on the simplifying assumptions that (1) the guaranty is a nine-year term, (2) the trust has some positive equity value of $250,000 cash to satisfy administrative expenses and some (if not all) interest payments, (3) interest (if not paid) can accrue until maturity, (4) the risk of default is likely at the maturity of the note, and (5) the trust assets have a volatility of 20 percent.

In fact, Figure 1 illustrates the potential profit or loss of the guarantor in this hypothetical scenario. The maximum profit for the guarantor (the green area) is the premium received (the $345,000); whereas, the maximum loss for the guarantor (the red area) is the maximum potential guaranty amount net of the guaranty fee (or premium) received ($655,000 or $1 million less the guaranty fee of $345,000).

Summary and Conclusion

Guaranty fees for intrafamily promissory note transactions are becoming more commonly used by families in estate and gift tax regulated transactions.

This discussion provided a background about guaranty fees and some valuation considerations during the guaranty fee analysis. Although this discussion provided an example and a means to estimate that guaranty fee, every guaranty fee arrangement is unique, and each valuation will be different based on case-specific facts and circumstances. That is, the BSOPM may be a method to estimate the intrafamily guaranty but it may not be the best method (or the only method) to apply in all situations.

The guaranty fee analysis can be quite complicated. A robust analysis is often required to analyze the factors in each situation.

Guaranty fee valuation reports prepared for a gift (or estate) tax filing purpose often require a qualified appraisal report. This type of report can assist the taxpayer in establishing "adequate disclosure" under the requirements set forth by the Service in Regulation 301.6501(c)-1(f)(3).

If the taxpayer can document that the guaranty fee paid by the borrower to the guarantor is at an arm's-length amount that is consistent with the fair market value of the guaranty, then the taxpayer would disclose and report to the Service that no gift was made by virtue of the guaranty among the parties.

Notes:

1. *Merriam-Webster's Collegiate Dictionary*, 11th edition (Springfield, MA: Merriam-Webster, 2003), 554.
2. *Funk & Wagnalls Standard Desk Dictionary* (New York: Funk & Wagnalls, 1984), 285.
3. See I.R.C. Section 1274(d)(1)(C).
4. I.R.C. Section 7872(e)(1): The term "below-market loan" means any loan if (a) in the case of a demand loan, interest is payable on the loan at a rate less than the applicable federal rate or (b) in the case of a term loan, the amount loaned exceeds the present value of all payments due under the loan.
5. Martin M. Shenkman, Esq., Heckerling Institute 2017, Thursday, Day 4, Notes (January 13, 2017), 17 (provided by Leimberg Information Services, Inc., Steve Leimberg's Estate Planning Email Newsletter Archive Message #2504).
6. http://www.theoptionsguide.com/bull-put-spread.aspx
7. The basic BSOPM can be modified for dividends on the underlying assets.

Exhibit 1
Hypothetical Guaranty Fee Arrangement
Valuation of the Guaranty Fee Based on a Bull Put Spread
Black-Scholes Option Pricing Model Analysis

		Short Put	Long Put
Current Fair Market Value of the Underlying Investment [a]	$ 10,000,000	Option #1	Option #2
Current Fair Market Value of the Trust Other Assets (cash)	$ 250,000	Sell at	Buy at 10% Below
Total Fair Market Value of the Trust Assets	$ 10,250,000	$ 10,000,000	$ 10,000,000
Standard Deviation [b]		20%	20%
T = Time to Expiration in Years [c]		9	9
S = Stock Price		$ 10,250,000	$ 10,250,000
R = Risk-Free Rate [d]		2.38%	2.38%
E = Exercise Price		$ 10,000,000	$ 9,000,000
D = Dividend Yield [e]		0%	0%
N(d1)		0.7575	0.8089
N(d2)		0.5391	0.6079
N(-d1)		0.2425	0.1911
N(-d2)		0.4609	0.3921
d1		0.6982	0.8738
d2		0.0982	0.2738

Option Pricing Model Formula: P = Ee(-RT)N(-d2) - Se(-DT)N(-d1)

Put-Call Parity Equation: C = P - present value(E) + S

	Guarantor Equivalent Value		
Value of Selling a Put Option (obligation to buy) - Cash Inflow	+ $ 1,234,325	$ 1,234,325	
Value of Buying a Put Option (right to sell) - Cash Outflow	- $ 889,707		$ 889,707
Net Premium Received	$ 344,619		
Percentage of the Total Cost of Selling an At-the-Money Put Option	*27.9%*	*100.0%*	*72.1%*
Value of the Bull Put Spread Position [rounded]	**$ 345,000**	3.45% of Note Principal	

[a] The purchase by the trust of the securities of a private investment entity was transacted as of the valuation date at a determined fair market value of $10 million.
[b] Volatility is based on the portfolio volatility of the underlying securities (both cash and the private investment interest) held by the trust, as the volatility of the underlying assets of the trust will be the volatility of the trust.
[c] The estimated liquidation time horizon of nine years is based on the hypothetical assumptions that the note used to acquire the private investment interest is a nine-year note and the guaranty arrangement is consistent with the life of the note.
[d] Based on linear interpolation of the yields to maturity on 7-year Treasury bond and 10-year Treasury bond as of the valuation date.
[e] Since the trust is not anticipated to receive dividends from the private investment entity, the dividend yield variable is not applicable to the subject analysis.
Note: Simplifying assumptions have been made in this example for illustration purposes.

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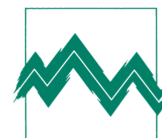

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Valuation Discounts for Family Limited Partnerships and Family Limited Liability Companies

Chad M. Kirkland and George H. Haramaras

The family limited partnership ("FLP") and family limited liability company ("FLLC") are two types of entities that may be used in trust and estate planning. Families use such entities to achieve multiple strategies, including (1) the intergenerational transfer of family wealth, (2) the protection of assets, and (3) the consolidation of assets to achieve economies of scale related to administrative costs. The valuation analyst can provide expertise in navigating the topics that frequently arise when valuing these family asset holding entities. First, this discussion focuses on the application of the generally accepted business valuation approaches in the context of an FLP or an FLLC. Second, this discussion examines the application and derivation of valuation discounts for a noncontrolling ownership interest in an FLP or an FLLC.

Introduction

Valuation analysts are often engaged to estimate the value of interests in family limited partnerships ("FLPs") and family limited liability companies ("FLLCs") for estate and gift tax reporting and/or planning purposes. Such entities are typically closely held and the level of value sought in these engagements is typically a noncontrolling, nonmarketable ownership interest level of value.

The FLP and FLLC are two distinct types of legal entities that are often used by families for asset protection and wealth transfer purposes.

In the valuation analyses of FLP and FLLC interests, the generally accepted asset-based business valuation approach is often applied. In particular, the asset accumulation business valuation method (of the asset-based approach) is often applied. However, the generally accepted business valuation market approach and income approach can also be applied to provide analytical support for valuation discounts that may apply to noncontrolling, nonmarketable FLP and FLLC interests.

This discussion defines FLPs and FLLCs, describes the application of generally accepted business valuation approaches to FLPs and FLLCs, and summarizes the data relied on and the factors that influence the discounts that may apply in estimating the fair market value of a noncontrolling, nonmarketable FLP and FLLC ownership interest for estate and gift tax compliance purposes.

Definition of FLP and FLLC

An FLP is a type of partnership. It is important to note that in the legal context, an FLP is not a distinct type of legal entity; it is a traditional limited partnership that is defined by its business objectives. An FLP is typically used by families for asset protection and wealth transfer purposes, but FLPs also achieve other business objectives.

As the name implies, family members comprise the partnership interests in an FLP. FLP partnership interests consist of the general partnership interest, where the general partner typically retains control

and has unlimited liability in the entity. The limited partner in an FLP typically retains a noncontrolling interest in the entity and has limited liability in the entity.

Similarly, an FLLC is a limited liability company ("LLC") that is defined by its business objectives and is formed by family members. Members of LLCs enjoy limited liability in the entity and are taxed comparably to partnerships. FLLCs, among other business entities, are used by families for asset protection and wealth transfer purposes.

Some of the attributes of FLPs and FLLCs are the business objectives of asset protection and wealth transfer. Typically, FLPs and FLLCs are formed when senior members of a family contribute assets to the entity in exchange for general partner or limited partner interests in the FLP or membership interests in the FLLC.

Assets contributed to an FLP or an FLLC are typically comprised of the assets that senior family members have accumulated.

It is important to note that these investment assets can vary greatly. According to the business valuation textbook, *Comprehensive Guide for the Valuation of Family Limited Partnerships*, the types of assets held by an FLP may include, but are not limited to, the following:[1]

- Marketable securities
- Income-producing real estate
- Non-income-producing real estate
- Multiple asset types
- Oil and gas interests

Lastly, while the assets contributed to FLPs and FLLCs are diverse, the ultimate operations of such entities are frequently straightforward. Typically, FLPs and FLLCs are business entities that operate as investment management holding companies and require minimal day-to-day management.

This business structure contrasts with operating businesses, where operations include actively managed activities such as the manufacture, distribution, and sale of products and services.

To reiterate, FLPs and FLLCs:

1. are defined by their business objectives, including asset protection and wealth transfer for families and
2. are typically operated as passive business entities that hold investment assets.

Such investment assets vary greatly from entity to entity.

Given these facts, one can conclude that while FLPs and FLLCs share commonalities, they can also vary greatly when evaluated as a group—specifically in the context of the underlying investment asset compositions, ownership limitations, and management restrictions.

Applying Generally Accepted Business Valuation Approaches to FLPs and FLLCs

While many analysts valuing ownership interests in FLPs and FLLCs often apply the asset-based approach in all situations—given the asset-centric composition of these entities—the variation in the FLP and FLLC underlying assets requires the analyst to develop a more nuanced examination.

While FLPs and FLLCs have similarities across entities, the analyst should consider the details and attributes of FLP and FLLC ownership interests on an individual basis, rather than applying one approach for all types of FLP and FLLC ownership interests.

Accordingly, the analyst should consider all generally accepted business valuation approaches when valuing FLP and FLLC entities. The implementation of these business valuation approaches is discussed next.

Asset-Based Approach

The asset-based approach is a frequently applied approach when estimating the value of FLP/FLLC ownership interests. Despite this, the analyst may nonetheless exercise discretion when selecting an approach in the valuation of FLP and FLLC interests; the analyst should not universally apply the asset-based approach in all situations involving FLP and FLLC interests.

The asset accumulation method is one method of the asset-based business valuation approach. In the asset accumulation method, assets and liabilities are adjusted to their fair market values. The fair market value of liabilities is then subtracted from the fair market value of assets to arrive at an indicated value for the FLP or FLLC.

The analyst may apply various property valuation approaches and methods to estimate the fair market value of the underlying assets. Estimating the fair market values of assets and liabilities can consist of obtaining readily available market values, performing separate valuation analyses (including income approach and market approach methods), and/or relying on the opinions of other professionals with expertise in such areas including, but not limited to art, real estate, and oil and gas interests.

It is important to note that the value indicated by applying the asset-based approach is often concluded on a controlling, marketable ownership interest level of value basis. That is because the fundamental assumptions of the asset-based approach presume control and ease of marketability.

Specifically, the asset-based approach indicates a value of the FLP or the FLLC by estimating fair market value as if the investment assets were sold. In order to actually realize the implied value of this assumption, the owner of the FLP or FLLC subject interest would need to:

1. have control of the subject entity to execute such a decision and
2. have access to markets that would purchase the underlying assets at the fair market value.

Since FLP and FLLC ownership interests frequently do not enjoy control of the entity, and since both FLP and FLLC ownership interests are typically closely held with no active market, where applicable, adjustments should be made to develop the fair market value of the FLP or FLLC ownership interest on a noncontrolling, nonmarketable level of value basis.

Income Approach

As it relates to FLP and FLLC ownership interests, the income approach, and specifically the discounted distribution method, can provide support in estimating an appropriate discount from net asset value for FLP and FLLC noncontrolling, nonmarketable ownership interests.

The application of the income approach discounted distribution method to provide support for appropriate discounts from the asset-based approach is presented in a later section of this discussion.

Market Approach

The market approach can also be considered when valuing FLP or FLLC ownership interests. The market approach involves the analysis of comparable ownership interests trading in an open market, in order to estimate the value of the FLP or FLLC subject interest.

Often, the analyst may be unable to apply the market approach because of the lack of guideline company data relevant to the FLP or FLLC subject to analysis.

More specifically, the analyst may be unable to apply the guideline publicly traded company method of the market approach. This is because, in many cases, there may not be any publicly traded companies that are reasonably comparable to the subject FLP or FLLC.

Similarly, the analyst may be unable to apply the guideline merged and acquired company method of the market approach. This is because, in many cases, there may be a lack of transaction data of merged and acquired entities that are reasonably comparable to the subject FLP or FLLC.

The analyst's decision to not apply a market approach in the valuation of the FLP or FLLC ownership interest can be a subject of question. Those who advocate for applying the market approach often state that the public markets include several entities (e.g., open-end mutual funds, closed-end mutual funds, publicly traded investment companies, publicly registered limited partnerships) that are in a primary business similar to that of the subject FLP or FLLC.

Perhaps the most significant fundamental difference between these publicly traded entities and a closely held FLP or FLLC is the difference in the marketability of the entities' ownership interests.

Thus, even in the situation where the analyst is able to identify entities that are sufficiently similar to the subject FLP or FLLC to be used in the guideline publicly traded company method, the analyst is still faced with the need to adjust, typically by applying a discount, the indicated value of the FLP or FLLC ownership interest.

Estimating and Applying Valuation Discounts for FLP or FLLC Interests

In addition to applying generally accepted valuation approaches, in many situations involving FLPs and FLLCs, a discount (or a series of discounts)is warranted. Discounts applied to FLPs and FLLCs arise from the attributes of these entities that decrease (or adversely affect) the desirability of these ownership interests as investments.

Most broadly, discounts applied to ownership interests in FLPs and FLLCs reflect a lack of (1) ownership control and (2) marketability.

Consolidation of control is often in line with the objectives of the FLPs and FLLCs. It is common in FLPs and FLLCs for certain family members to maintain control of the entity.

In many situations, an older generation—frequently the parent generation—has accumulated wealth and wants to ensure that wealth is preserved and effectively managed for subsequent generations.

The older generation may have technical experience investing in, managing, and preserving FLP/FLLC assets.

Lastly, the older generation may want to ensure that family wealth is responsibly preserved for subsequent generations and not squandered by the younger, less experienced generation.

Discounts for lack of control often arise from the frequent structure of FLPs and FLLCs, where one ownership interest enjoys control of the entity and thereby determines:

1. the business strategy,
2. the level of distributions, and
3. the bylaws of the entity.

A noncontrolling ownership interest in the FLP or FLLC is inherently less desirable to potential investors, as investing in such an interest means forgoing control in the investment.

In some situations (specifically when the underlying assets are predominantly marketable securities), an investor could hypothetically invest in or recreate the asset holdings of an FLP or FLLC and operate the identical portfolio while enjoying control. This consideration would, therefore, imply that a noncontrolling interest in a portfolio of assets would require a discount compared to an interest in an identical portfolio of assets where control is retained.

Discounts for lack of marketability generally are affected by the level of distributions the entity pays out, the expected holding period of the interest, and the underlying risk inherent in the specific FLP/FLLC entity. FLPs and FLLCs, like any entity, have unique attributes that color the consideration of the discount for lack of marketability.

Specifically, FLP/FLLC ownership interests are typically privately held and tightly controlled by one or multiple family members, as previously mentioned. Such characteristics make interests in FLPs and FLLCs less marketable, as the attributes increase the uncertainty of distributions, increase the level of company-specific risk, and increase the uncertainty surrounding the ability to sell or transfer the interest in an FLP/FLLC.

When applying valuation discounts for FLP and FLLC ownership interests, it is important that the analyst consider the nuances and specifics of the subject interest. In other words, valuation discounts should be applied on an individual basis, based on the unique facts of the subject interest.

Similarly, when estimating the appropriate discount, the data and research used to arrive at a conclusion should also be tailored to reflect the nuances of the subject interest. Applying valuation discounts for FLPs and FLLCs is discussed later in this discussion.

Most of the evidence that analysts rely on to estimate the discount for lack of control and the discount for lack of marketability is based, at least in part, on the analysis of transactions of publicly traded common equity securities. The discount from net asset value for lack of control and the discount from net asset value for lack of marketability can be separately estimated by relying on empirical studies.

Data for privately negotiated limited partnership interest transactions can also be analyzed. The transaction price discount, if any, from the partnership's net asset value, would inherently reflect aspects of both the lack of control and the lack of marketability.

When the analyst is estimating the value of a noncontrolling ownership interest in an FLP or FLLC by applying the asset accumulation method, the analyst may quantify appropriate valuation adjustments.

A noncontrolling ownership interest in an FLP or FLLC is typically subject to transferability restrictions and to other limitations that are not reflected in the market value of the underlying assets owned by the entity.

Some of these ownership interest restrictions and limitations may include the following:

- The inability to influence, in any way, the management and operations of the entity
- Lack of control over dividends/distributions
- The inability to realize the asset values of the entity until a sale or liquidation
- Restrictions on the sale or transfer of equity interests

Discount for Lack of Control

The difference in price that an investor will pay for a controlling ownership interest in a limited entity compared to an otherwise noncontrolling ownership interest in the same limited entity may be considerable. This difference in price is often referred to as the discount for lack of control ("DLOC").

The DLOC measures the difference in price between:

1. a controlling ownership interest and
2. an otherwise comparable noncontrolling ownership interest.

DLOC Factors

One of the important variables affecting value is the degree of control rights, if any, inherent in the inter-

est being valued. The value associated with ownership control depends on the ability to exercise any or all of a variety of rights typically associated with ownership control.

As a result, the value of a noncontrolling interest is not necessarily equivalent to the pro rata percent of the value of the entire enterprise or the underlying adjusted net asset value.

By definition, the holder of a noncontrolling ownership interest lacks control, and has little or no voice in entity affairs. The following list provides examples of some of the prerogatives of control:

- Appoint or change management
- Determine management compensation and perquisites
- Set operational and strategic policy and change the course of business
- Acquire, lease, or liquidate assets
- Borrow funds on behalf of the entity
- Select people with whom to do business and award contracts
- Negotiate and consummate mergers and acquisitions
- Liquidate, dissolve, sell out, or recapitalize, the company
- Declare and pay distributions
- Block any or all of the above actions

A willing buyer contemplating the purchase of a noncontrolling ownership interest from a willing seller would consider the disadvantages arising from a lack of control. Therefore, regardless of the controlling ownership interest value of a company, one would not expect a willing buyer to purchase a noncontrolling ownership interest except at a price discount from its pro rata share of the controlling ownership interest value of an entity.

Theory and Rationale for DLOC Adjustments in Limited Entities

The DLOC adjustment is often quantified using pricing of publicly traded—or thinly traded—securities. Market data that are typically applied to support a DLOC are as follows:

1. Price to net asset value data derived from shares of publicly traded closed-end mutual funds
2. Acquisition price premium data derived from transactions involving publicly traded common stock
3. Price to net asset value data derived from units of publicly registered limited partnerships traded on the secondary over-the-counter deal market

Closed-End Mutual Fund Data

Publicly traded closed-end mutual fund pricing data can be used as support for estimating a DLOC for a noncontrolling ownership interest in an FLP or FLLC.

Much like a closed-end mutual fund, where a shareholder's return is dependent upon the fund manager's success in managing the fund portfolio, the return on investment to an owner of a noncontrolling interest in an FLP or FLLC is dependent upon the success of the general partner or manager in managing the entity's portfolio.

It is noteworthy that publicly traded closed-end funds are similar to FLPs and FLLCs in many respects. In each case, the noncontrolling shareholder, limited partner, or noncontrolling member is:

1. in no position to influence the management of the portfolio and
2. bound by the terms of the prospectus, the partnership agreement, or the operating agreement, as the case may be.

This lack of control over the assets of the (1) the fund, (2) the partnership, or (3) the LLC provides a reasonable explanation as to why close-end fund shares, limited partnership interests, or LLC interests, often trade at a price discount to their net asset value.

However, publicly traded closed-end funds and FLP or FLLC ownership interests differ in a number of ways. For example, most publicly traded closed-end funds have a well-defined investment strategy and philosophy. A prospective buyer of closed-end fund shares can read the prospectus and understand how the fund's assets will be invested.

In contrast, most FLPs and FLLCs give a broad range of investment authority to the general partner or manager, as the case may be. As a result, the general partner or manager is usually able to invest in different asset classes (e.g., equities, bonds, real estate, and private investments) and change the composition of the investment portfolio at any time.

This difference suggests that there should be a greater DLOC for FLP or FLLC ownership interest than for ownership interests of publicly traded closed-end funds.

The price to net asset value discount derived by these funds can vary quite a bit depending on the following:

> "The consensus of analysts, judicial decisions, and empirical studies is that an investment is worth more if it is readily marketable and conversely, worth less if it is not readily marketable."

1. The type of closed-end fund
2. Market conditions

For example, the price to net asset value discount can range, on average, from 1 percent to 2 percent on the low end of the range to 30 percent to 35 percent on the high end of the range. The valuation analyst has discretion as to which closed-end funds to select for the analysis of the FLP or FLLC subject ownership interest, and this discretion has an impact on the DLOC that is ultimately applied in the analysis.

Noncontrolling limited partnership or LLC ownership interests are typically valued at a discount relative to the value of the entire enterprise.

The noncontrolling limited partner or member lacks the unilateral ability to dissolve the partnership or limited liability company and to obtain either an undivided interest in the entire assemblage of assets or a partitioned, marketable ownership interest representing his/her pro rata percentage of the value of the entire entity.

Acquisition Price Premium Data

Some of the objective evidence of the appropriate DLOC is the study of cash tender offers. By looking at price premiums offered during a tender for control of a company with publicly held shares, the analyst can approximate the pro rata value difference between controlling and noncontrolling shares.

Control price premiums vary widely, with the high end of the range being a price premium of over 100 percent and the low end of the range being a price discount—both ends of the range clearly indicating special factors involved. It is noteworthy that a price premium for ownership control of 25 percent to 40 percent is equivalent to a value DLOC of approximately 20 percent to 29 percent.[2]

While useful in providing guidance in the selection of a DLOC, it is important for valuation analysts to consider whether price premiums reported in empirical data contain considerations for synergistic value. All things considered, the presence of synergistic value would result in relatively larger price premiums, and thus, larger implied DLOCs.

Publicly Registered Limited Partnership Data

Data on publicly registered limited partnership interest transactions suggest that these interests typically sell at a discount from their pro rata portion of net asset value due primarily to lack of control, and secondarily, lack of marketability.

A limited partner has virtually no liquidity or influence over the economic aspects of a partnership. Therefore, it is not surprising that empirical evidence of limited partner interest transactions typically result in price discounts from adjusted net asset values.

It is important for the analyst to keep in mind that the data derived from trades in the over-the-counter secondary market for these limited partnership interests probably include both (1) lack of control factors, and due to the thinly traded nature of the secondary markets in registered limited partnership interests, (2) factors related to a lack of marketability.

Discount for Lack of Marketability

After quantifying a DLOC to apply to a noncontrolling interest in an FLP/FLLC, the analyst is still faced with the additional procedure of quantifying a discount for lack of marketability ("DLOM") for the noncontrolling ownership interest.

The consensus of analysts, judicial decisions, and empirical studies is that an investment is worth more if it is readily marketable and conversely, worth less if it is not readily marketable.

The difference in the price an investor will pay for a liquid asset compared to an otherwise comparable illiquid asset can be substantial, and it is often referred to as the "DLOM."

Analysts typically rely on two types of models to quantify the appropriate DLOM:

1. Empirical models
2. Theoretical models

Generally, empirical models apply analyses that are based on empirical capital market transaction observations—rather than on theoretical economic principles. In contrast, theoretical models do not rely on actual capital market pricing evidence, but are based on fundamental microeconomic relationships.

There are two categories of empirical studies that are often considered to quantify the DLOM noncontrolling ownership interests in closely held companies:

1. Studies of price discounts on sales of restricted shares of publicly traded companies (the "restricted stock studies")

2. Studies of price discounts on private stock sale transactions prior to an initial public offering (the "pre-IPO studies")

Based on the unique attributes of the noncontrolling ownership interest in the FLP/FLLC subject to valuation, there are times when one type of study is more relevant than another type of study. This is due to the fact that there are varying degrees of marketability, which depend on the circumstances inherent in each valuation analysis. In other words, marketability and lack of marketability are relative (and not absolute) terms.

Generally, it is important for the analyst to have a thorough understanding of how the noncontrolling ownership interest in the FLP/FLLC subject to the valuation analysis compares to the interests analyzed in the various empirical DLOM studies.

For example, if the ownership interest in the FLP/FLLC subject to the valuation analysis has an expected holding period of two years or less, then it may be more meaningful to place more emphasis on the results from the restricted stock studies than the results from the pre-IPO studies.

In contrast, if a public market or liquidity event is not expected to occur for many years, then the results form the pre-IPO studies may be more meaningful to the analysis.

The selected DLOM may ultimately be based on FLP-specific and FLLC-specific factors such as the following:

- Interim distributions or dividend payments (returns received on an investment prior to a return of the investment)
- Subject entity risk (various cost and volatility factors that increase or reduce the certainty of positive or negative events influencing returns)
- Expected holding period for the subject interest (time horizon factors that influence the length of time until a liquidity event)

Income Approach—Discounted Distribution Method

In addition to the empirical studies and market-based evidence mentioned above, the income approach, and specifically, the discounted distribution method ("DDM"), may provide support in estimating an appropriate discount (if any) for noncontrolling, nonmarketable ownership interests in FLPs and FLLCs.

One indication of the value of the asset is the present value of the asset's expected returns. Based on this principle, the analyst may value a noncontrolling ownership interest in an FLP or FLLC by estimating the present value of the expected total returns related to the ownership interest. These returns can come in the form of annual income distributions, or can also come in the form of capital distributions from the sale or distribution of partnership or company assets.

A case can be made that the further removed a particular ownership interest is from controlling the FLP or FLLC (e.g., a limited partnership or noncontrolling membership interest), the more important income distributions are to the noncontrolling interest holder.

In other words, if a limited partner or noncontrolling member is unable to control the timing of asset sales, the distribution of asset sale proceeds, and the termination and liquidation of the FLP or FLLC, the limited partner or noncontrolling member, as the case may be, will depend exclusively on income distributions as a means of its return.

Principle Procedures in the Discounted Distribution Method

Essentially, there are four procedures in the DDM.

The first DDM procedure is to develop financial projections for the subject entity. This procedure considers the entity's current investment portfolio and how that portfolio may change over time. If the entity's current investment portfolio allocation is different than its expected long-term investment portfolio allocation, then the analyst can reallocate the projected investment portfolio allocation in accordance with the long-term expectations.

Based on the current and/or projected allocation of the entity investment portfolio, the analyst is able to project the income and the capital appreciation for each segment of the investment portfolio.

When estimating the projected net economic income of the entity, the analyst should subtract any operating expenses (e.g., legal, accounting, administrative) for the entity from the total income.

The second DDM procedure is to develop a distribution payout schedule. This procedure may involve a thorough review of the entity's partnership or operating agreement to understand if, when, and how distributions will be paid by the entity. It is typical for the analyst to consult with entity management and/or legal counsel at this stage of the analysis.

The third DDM procedure is to estimate the terminal value of the entity investment portfolio.

Often, there is uncertainty regarding the expected holding period of the investment. The analyst may project a discrete terminal value of the entity investment portfolio for several different expected holding periods.

The fourth DDM procedure is to estimate the appropriate present value discount rate to apply in estimating the present value of the entity distributions and terminal value. It is important that the selected present value discount rate reflects all of the risks inherent in owning a noncontrolling, nonmarketable level of value ownership interest in the subject FLP or FLLC.

Generally, it is not appropriate to apply the estimated annual return of the FLP or FLLC investment portfolio as the present value discount rate. The selected present value discount rate should reflect the risk for the lack of control and the lack of marketability inherent in a limited partnership or LLC membership interest.

The analyst may consider various market data to support an estimated annual return for a noncontrolling, nonmarketable level of value ownership interest. These data may include the following:

1. Rates of return on publicly registered, thinly traded limited partnership interests
2. Expected rates of return on illiquid private equity investments
3. Historical and expected rates of return on micro-cap common equity investments

The sum of the present value of (1) the entity projected distributions and (2) the entity projected terminal value indicates the fair market value of the entity equity on a noncontrolling, nonmarketable ownership interest level of value basis. Thus, there is no need for the analyst to apply a DLOC or DLOM to the value conclusion.

The fair market value of the entity that was estimated by applying the DDM may be compared to the undiscounted net asset value of the entity to compute the total discount that is implied by the DDM. It is noteworthy that this implied discount is a combined DLOC and DLOM. This combined discount can be used as support for the selected DLOC and DLOM.

Summary and Conclusion

FLPs and FLLCs are often formed and used by families for asset protection purposes, wealth transfer purposes, and wealth consolidation purposes. FLPs and FLLCs are typically comprised of the investment assets that a family has accumulated.

Analysts are often retained to estimate the value of a noncontrolling ownership interest in an FLP or an FLLC. The asset-based business valuation approach is often applied in these valuation analyses, and the income approach, and specifically the DDM, can be used for support of an appropriate discount to apply to the noncontrolling, nonmarketable level of value interest in the FLP or FLLC.

Further, analysts typically rely on empirical studies that are based on empirical capital market transaction or pricing observations to estimate the appropriate DLOC and DLOM to apply to noncontrolling, nonmarketable level of value interests in FLPs and FLLCs.

Market data relied on to support an appropriate DLOC may include the following:

1. Closed-end mutual fund data
2. Acquisition price premium data
3. Publicly registered limited partnership data

Market data relied on to support an appropriate DLOM may include the following:

1. Restricted shares of publicly traded companies
2. Private stock sale transactions prior to an initial public offering

Analysts typically consider the unique facts and circumstances of the specific FLP or FLLC subject ownership interest when estimating the appropriate valuation adjustments that may apply.

Notes:

1. Bruce A. Johnson, Spencer J. Jeffries, and James R. Park, *Comprehensive Guide for the Valuation of Family Limited Partnerships*, 4th ed. (Argyle, TX: Partnership Profiles, 2017), vi.
2. Price discount is calculated as 1 – [1/(1+price premium)].

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Valuing Art Fund Investments for Estate and Gift Tax Purposes

Weston C. Kirk

Investors with large artwork collections may contribute these assets to an investment management entity that will hold, acquire, sell, manage, and protect the works of art. These entities are often referred to as art funds. An interest in an art fund may be a significant investment holding that is transferred to a beneficiary during life or at death. For gift or estate tax purposes, these transfers require independent valuation analyses—typically both an independent art appraisal and an independent business valuation.

Introduction

This discussion outlines the business valuation aspects to developing the fair market value of an investment interest in an art fund transferred for estate and gift tax purposes.

For purposes of this discussion, art funds are defined as entities, typically limited partnerships or limited liability companies, that invest in artwork. There are both private institutional art funds and private investor organized (often family-owned) art funds. Currently, there are no publicly listed or publicly traded art funds.

Investors in art may:

1. acquire artwork directly for their personal enjoyment,
2. acquire a noncontrolling interest in a private institutional art fund managed by professional investors, or
3. acquire (or form) a private-investor-backed art fund to commingle funds (or artwork).

This discussion addresses the important aspects that constitute the business valuation of an art fund investment interest transferred for estate or gift tax purposes.

Art Funds

Art funds are often organized to hold, acquire, sell, manage, and protect works of art. Art is considered a subcategory of alternative investments.

Institutional art funds are investment funds that may be structured like hedge funds and marketed to accredited investors. Investors (or limited partners) pool funds to invest in specific types of artwork. Institutional art funds raise capital and focus investment on a specific genre (e.g., old masters, contemporary, pop art, expressionism, postmodern) and a specific form of art (e.g., paintings, sculpture, photography, video, prints).

Management and Operations

Often managed by professional managers or advisory firms, institutional art funds seek to provide a return on investment through the appreciation and ultimate sale of its underlying assets. These managers (or general partners) may co-invest with the accredited investors.

The general partners typically charge both:

1. an annual management fee between 1 percent and 3 percent (based on the fund net asset value or total capital commitments) and
2. a performance fee (i.e., carried interest or success fee) equal to 20 percent of any profits made from the disposition of the fund's art portfolio.

Most institutional art funds have a termination date (e.g., 10 years), which limits the existence of the fund and indicates a date when an investor can expect a return of capital.

However, during this term, institutional funds may have reasonable avenues for investors to request a redemption of their interest by the fund, such as a quarterly redemption cycle. These types of funds may also have significant gate clauses or penalties for early redemption.

Private investor art funds are often not managed with the same fee structure as most institutional art funds. Private investor art funds are formed to commingle funds or existing artwork for collective management and asset protection. Private investor art funds are often less restricted than institutional funds, allowing for more concentrated and diverse discretion in the selection of art holdings.

Private funds may invest solely in one artist. Most institutional funds are diversified both from a value per work perspective and from an artist perspective.

Most private funds are not managed by professional private equity investment managers or professional art experts, such as institutional art funds. Rather, they are more likely managed by art enthusiasts. Private funds often do not have maturity dates that require the sale or dissolution of the fund.

Private funds may not have redemption provisions for an investor to exit the investment. Oftentimes, private investor art fund investments are less marketable and less liquid than that of institutional art fund investments.

The managers of both types of art funds perform several tasks on behalf of the fund and its investors, such as the following:[1]

1. Identify potential acquisitions
2. Raise capital for the fund
3. Manage investor relations
4. Handle administrative compliance of the fund
5. Showcase the investment portfolio through exhibitions and loans to museums
6. Manage the investments (e.g., storing and properly insuring the art)
7. Monitor the art market in general and the fund's artists in particular
8. Manage the orderly disposition of the fund's investment portfolio

Income and Expenses

Both types of art funds realize income from either:

1. renting or leasing art to individuals, companies, galleries, museums, or the like or
2. selling art through private sales or at auction.

When a fund rents or leases its art, the fund may incur some portion of restoration costs prior to or after exhibition, crating and shipping costs, and insurance costs. Arranging art for display in museums and galleries tends to increase the prominence of the art and thus increases the value of the art. Therefore, museums and galleries do not often pay rent for artwork they put on display for the fund; instead, the value to the investor is derived from the artwork's appreciation in value.

In these instances, the museum or gallery will also share in the cost of restoration (if any) and the shipping and handling of the artwork to and from the venue.

The majority of an art fund's income is realized at sale. Private sales and art auctions are often brokered by a dealer that helps an investor realize the highest sale price (or hammer price). For creating the pool of potential buyers, marketing the art, and orchestrating the sale process, private brokers and auction houses charge a fee (or commission). These commissions—which are negotiated and are determined on a case-by-case basis—often range from 5 percent to 25 percent of the hammer price.

In rare instance, seller fees may be waived on certain items. In addition to sales commissions, some auction houses can also charge storage fees, photo fees, promotional fees, insurance fees, and shipping fees. The net sales price (net of commissions and fees) is often used by institutional art funds to extract a performance fee for the general partners (often 20 percent of realized proceeds above the art's initial acquisition cost).

Private art funds may not have such performance fees, and the proceeds may either be re-invested or distributed to the owners.

In addition to the costs realized at sale, both types of art funds also incur material direct expenses. These expenses include management fees, legal fees, accounting fees, appraisal fees, insurance fees, storage fees, shipping and handling fees, and maintenance and restoration fees.

Management fees for institutional funds are often more than private investor funds. Management fees are often 1 percent to 3 percent of the assets under management. Although the balance of the fees listed above are variable, such fees are not dissimilar between the two art fund categories.

Investor Returns and Risks

In all, the investor's return on investment from an art fund is often measured by the internal rate of return. Unlike finding personal enjoyment in the art acquired on an individual basis, a noncontrolling investment in an art fund is often a passive investment strategy wherein the investor is seeking a risk-adjusted return and overall portfolio diversification.

In the *Art & Finance Report 2017*, the latest report published by Deloitte Luxembourg and ArtTactic, the report indicated that there had been a continued decline in institutional art fund assets under management since 2012, which represented a record year. In 2012, there were 115 art funds (90 of which were in China). The actual size of the art investment fund market is likely to be bigger than the publicly available data suggest.

According to the *Art & Finance Report 2017*, assets under management in art funds had decreased nearly 62 percent since 2012 from approximately $2.17 billion to an estimated $834 million. This estimate of the art fund market in 2017 was down from $1.03 billion in 2016 and $1.20 billion in 2015.

This trend is principally driven by regulatory oversight in China, France, and the United Kingdom, and by stricter regulations on unregulated collective investments. However, there are signs of new entrants to the market, especially in Europe and the United States.

Five concerns held by art fund investors are valuation (mark-to-market), due diligence, lack of a track record, lack of regulation, and lack of liquidity.[2]

However, proponents for art fund investment suggest that the lack of regulation, deficient price discovery mechanisms, nontransparent markets, subjective value, and illiquid nature of fine art enables them to generate arbitrage opportunities that seasoned art professionals can exploit for the benefit of their investors, yielding alpha returns.

Further, some investors believe art provides portfolio diversification benefits, a store of value, and acts as a hedge to inflation as a noncorrelated asset.[3]

Overview of Art Appraisals

In the valuation of an investment interest in an art fund, an art appraisal is often required to identify the current fair market value of the fund's assets.

An art appraisal report follows some of the same tenants of a business valuation report. An art appraisal that is prepared in a manner consistent with the *Uniform Standards of Professional Appraisal Practice* will typically include, among others, the following:[4]

1. Client information and appraiser information and qualifications
2. Signed and dated certification
3. Scope of work
4. Purpose of the appraisal
5. User of the report
6. Type of report (e.g., self-contained, summary, restricted)
7. Approach to value (e.g., market data comparison approach, cost approach, income approach)
8. Type of valuation used (e.g., retail replacement, marketable cash valuation)
9. Marketplace in which the valuation is applied
10. Relevant dates (e.g., effective valuation date, issue date of the report, date of inspection)
11. Description of the appraised works of art, including a description of the artist, title, date, size, medium, condition and quality, provenance, exhibition and publication history, and the like
12. Photographs of works appraised (as objects valued at $20,000 or more require a photograph for gift and estate tax purposes)
13. Comparable sales data of similar works
14. Assignment considerations, assumptions, and limiting conditions

For artwork, fair market value of a subject work is often based on what comparable works have sold for in recent years.

Private sales may lead to a higher price than auction sales. This is often due to the buyer (and/or seller) preferring anonymity or the desire by the buyer to fill a gap in his or her collection, despite paying a premium above historical auction sales of comparable works. However, private sales prices are not always higher than auction sales.

Auction sales of prominent works often exceed the private sales market price given the hype at auction.

Art appraisers may use various auction result databases in their analysis. Some of these databases include Artnet, Artprice, Artsy, AskArt, 1stDibs, and Invaluable. Auction house websites and catalogues, as well as art galleries, may also be relied on in the sales price of comparable works.

An art appraiser will often analyze the work on a highest and best use basis, applying a method that best represents the value of the piece at a point of time. The appraiser will also apply his or her best judgment and knowledge of the art market in determining fair market value.

Overview of Art Fund Business Valuations

In valuing an investment interest of an art fund, a valuation analyst ("analyst") considers all generally accepted business valuation approaches and methods in the analysis. Additionally, the analyst considers the contractual provisions of all applicable legal agreements.

The three generally accepted business valuation approaches are (1) the income approach, (2) the market approach, and (3) the asset-based approach. Within each approach, there are several generally accepted business valuation methods.

Two art fund valuation methods that are often applied to estimate the value of an art fund investment interest are as follows:

1. The adjusted net asset value ("ANAV") method (an asset-based approach method)
2. The discounted future distributions ("DFD") method (an income approach method)

The asset-based approach is readily applicable to estimate the value of an art fund. That is because the underlying assets can be discretely valued. The art fund's artwork can be contemporaneously appraised by a qualified art appraisal firm and by a qualified art appraiser.

Additionally, an income approach method can be applied to assess the investment's ability to generate distributable income from the projected income from sales of artwork.

The market approach is often not applicable in these alternative investment cases. This is because little to no guideline publicly traded, or recently acquired, company transaction data is available due to the private nature of art fund investing. In order to apply market-based methods, publicly disclosed pricing data needs to be identified in order to make a valuation comparison.

Although the market approach is often applied to estimate the value of discrete artworks, the market approach may be difficult to apply in the context of art funds.

In both business valuation methods (i.e., the ANAV method and the DFD method), the art appraisal(s) is (are) relied on by the valuation analyst. In almost all art fund valuation analyses prepared for gift and estate tax reporting purposes, both art appraisers and valuation analysts are required.

The following sections outline some of the analyst's considerations in developing the fair market value of art fund investment interests when applying an ANAV method and a DFD method.

The Art Fund Asset-Based Approach ANAV Method

In business valuation, the asset-based approach relies on methods that analyze the fair market value of an entity's assets (both tangible and intangible) and liabilities (both recorded and contingent). Indications of value for each asset and each liability are estimated in order to derive a value of equity.

One widely applied asset-based approach method is the ANAV method.

The ANAV method is an asset-based approach method applied to estimate the fair market value of business entity equity.

Estimating the Fair Market Value of the Art Fund Equity

In applying the ANAV method, the values of all of the business entity's assets are separately estimated under the value-in-continued-use premise. Each separate asset category is valued by applying the most appropriate valuation method. The values of all assets are accumulated to estimate the fair market value of all the assets of the business.

The current values of all liabilities, both current and long term, are also estimated. The values of all the liabilities are accumulated in order to estimate the fair market value of all the liabilities of the business entity.

To estimate the fair market value of the business entity equity, the fair market value of total liabilities is subtracted from the fair market value of total assets. This difference, or residual, represents the ANAV of the business entity equity.

The analyst reviews the art appraisals and rely on those findings in the analysis of the art fund.

Additionally, the analyst considers business valuation adjustments to the art appraisal values that

may not have been considered in the art appraisal. Most art appraisals estimate the value of each piece of art as if individually owned on a fee simple interest basis.

An art appraisal may not capture all of the valuation effects incurred as a collection of artworks held by an art fund. The analyst may need to consider if:

1. any works are co-owned (i.e., undivided interests) with other funds or investors,
2. any blockage discounts may be applicable given the quantum of assets held (either in quantity or by concentration), or
3. transaction expenses should be considered in the analysis of the art fund's equity attributable to the art fund investors.

When works of art are co-owned by multiple investors, undivided interest adjustments may apply. Tangible property undivided interests often incur a discount from a fee simple ownership interest basis under the fair market value standard. Owners of tangible property undivided interests often lack ownership control rights and liquidity (marketability).

Concentrations in investment holdings may incur a blockage discount under fair market value. Blockage discounts are applicable when the assets may incur market absorption issues. Blockage discounts analyze the time inherent in the process of orderly liquidating so that the total value of the assets is not depressed as a result of offering the assets on the market at the same time.

The analyst may discuss with the art appraiser whether the collection held by the art fund may be subject to blockage (i.e., market absorption) concerns. The analyst and/or the art appraiser may be able to quantify the blockage discount subject to the art fund specifically.

This blockage discount analysis may be determined using historical sales of comparable art and identifying the quantum of the artist's work that would be saleable per year without decreasing the demand (and, therefore, the price) of the artist's work. Based on historical and current trend data, the blockage discount analysis may determine the time to liquidate the works over a period of time.

A risk-adjusted present value factor may be applied over the duration of the anticipated sales cycle. Market absorption risk adjustments are often included in the art fund analysis if the works could not be sold within a relatively short time period (e.g., six months) at the current appraisal value on an individual basis.

Lastly, upon the sale of an art fund's works, the fund may be subject to material seller transaction expenses. If so, the art fund may have a contingent liability at sale. When the fund sells its works and distributes proceeds, the investors will receive net proceeds (net of transaction expenses from the auction or private sale).

Analysts may consider and incorporate in the ANAV method, as applicable, a reasonable estimate of transaction expenses charged at the sale of each artwork in order to estimate the value to the subject investor interest.

The analyst can discuss with the fund manager(s), art brokers, and the art appraisers what the potential sales commissions may be for each work. Seller transaction expenses often range from 5 percent to 25 percent of the appraised value.

In addition to the three adjustments, the analyst may consider whether the collection in its entirety enhances the value of other work held in the collection. Generally, this analysis is taken into consideration by the art appraiser, as the art appraiser will determine if certain works sold collectively may yield a higher value together as one lot. This factor is typically identified in the art appraisal report.

Based on these considerations, the analyst would adjust the value of the artworks appraised by an art appraiser, as applicable. These considerations assist in the analysts' development of the fair market value of the fund's artwork collection to the investors.

The analyst may also consider whether the art fund had any additional assets, including identifiable institutional goodwill (or other types of intangible assets) or off-balance-sheet assets.

Based on the total fair market value of the assets held by the art fund, the analyst may subtract any recorded, unrecorded, contingent, or off-balance-sheet liabilities that existed as of the valuation date. Most art funds have accrued accounts payable; some art funds may have other types of debt.

In the application of the ANAV method, the art fund's fair market value of total assets is subtracted from the fair market value of all of its liabilities. This procedure provides for an indication of the art fund's fair market value of a 100 percent investment interest of the fund, on a controlling, marketable membership interest level of value basis.

However, in the context of gift and estate tax transfers, analysts often value a noncontrolling ownership interest that may lack the ability to control the operating, investing, and financial decisions of the art fund. Further, the noncontrolling interest will often be illiquid, limiting the investor's ability to market and convert his or her interest into cash. Art fund operating agreements often include onerous transfer restrictions.

In these instances, an analyst may adjust the indicated fair market value of the subject interest on a pro rata value of equity downward to reflect the subject interest's lack of control and lack of marketability attributes.

Estimating the Fair Market Value of an Investment Interest

To identify the appropriate adjustment for lack of control, the analyst may consider, among other factors, the following:

1. The lack of authority associated with a noncontrolling interest to lease or generate income from the artworks prior to any sales
2. The lack of influence on the type of investments made by the company over the investment holding period
3. The lack of property diversification (e.g., concentrated art holding of two artists)
4. The lack of control over timing of distributions
5. Unregulated market concerns and lack of art investment council organizations to promote guidelines within the art fund sector
6. The inability to select
   a. where the art is displayed or stored or
   b. the opportunity to personally enjoy any work
7. The lack of discretion regarding brokers and their brokerage fees
8. The inability to manage and control costs, including variable restoration costs

In the art fund business valuation analysis, there are generally insufficient publicly available data on third-party transactions of noncontrolling interests in art funds. Therefore, analysts may rely on the implied discounts from the net asset value of publicly traded noncontrolling interests in real property, such as publicly registered limited partnerships ("PRLPs").

These PRLP interests typically trade at discounts relative to the value of their net asset value. This is because these noncontrolling entity interests lack unilateral control over the partnerships' underlying real estate assets.

These PRLP interests can provide a useful comparison to noncontrolling interests in art funds given that real estate and artwork are tangible assets often classified as alternative assets.

In addition to the discounts from net asset value of publicly traded noncontrolling interests, additional adjustments are often appropriate to reflect the relatively lesser rights and avenues of influence that private limited entity investors (such as an art fund investor) would have when compared to the rights and features of publicly registered investors.

These adjustments are based on (1) the art fund operating agreement (and other legal instruments) and (2) fund-specific factors

The art fund operating agreement often limits a noncontrolling investor's ability to manage or control the operating, investing, and financing decisions of the fund.

Fund-specific factors include, but are not limited to the following:

1. Quality of management
2. Property diversification
3. Age of the entity
4. Financial condition of the fund
5. Oversight and transparency for investors
6. Access to information
7. Use and enjoyment (if any) of the art work

Next, the analyst will consider the application of, and the adjustment for, the subject art fund interest's lack of public market transferability.

All other things being equal, an equity investment in a company is worth more if it is readily marketable or, conversely, worth less if it is not. It is well known that investors prefer liquidity to lack of liquidity, and interests in closely held companies are illiquid relative to most other investments.

Investments in art funds (especially, private-investor-backed art funds) are often very illiquid investments. Art fund investing is a relatively small market. Deloitte Luxembourg and ArtTactic estimate the market has continued a steady decline from $2.13 billion in 2012 to approximately $834 million in 2017.[5]

This trend is predominately due to a decline in Chinese art funds over the same time period from $1.48 billion to $373 million. The Art & Finance Report 2017 research found that in 2017, only 3 percent of art collectors were buying art for an investment purpose, whereas, 32 percent are buying for collecting purposes and 65 percent are collecting but with an investment view.

Furthermore, the research indicated that in 2017, approximately 59 percent of wealth managers thought the art fund industry was still too small, and that 72 percent of respondents thought lack of liquidity was a main investment hurdle.[6]

To identify the proper adjustment for lack of marketability, an analyst may consider, among other factors, the following:

1. The lack of an identified pool of potential investors for the noncontrolling interest (liquidity concerns)
2. The lack of identifiable or regular distributions (extending the payback period to an investor)
3. The block size and dollar value of the subject interest
4. The lack of mark-to-market valuations
5. The carrying expense burden of holding the subject interest and the risk of future capital calls to maintain the artworks

These adjustments may also be based on (1) the art fund operating agreement (and other legal instruments) and (2) fund-specific factors.

The art fund operating agreement often limits an investor's ability to transfer his or her interest or to withdraw from the fund.

Fund-specific factors may include, but are not limited to, the following:

1. Block size of the subject interest
2. Investment time horizon based on the anticipated time for the investor's return on capital (if any)
3. Level and certainty of interim cash flow (if any)
4. The prevailing market conditions for the subject interest and the commingled assets of the art fund

These valuation discounts are confirmed by the notion that the art fund investors would not be able to personally enjoy the artwork held by the fund, either by hanging such works in their homes or by directing such works to be displayed in venues of their choosing. If an investor seeks to invest in art, he or she can purchase artwork individually and be able to personally enjoy that work.

The Art Fund Income Approach DFD Method

The income approach is based on the principle that the value of a company is the present value of all the future expected economic income to be derived by the company's creditors and shareholders.

One of the methods of the income approach is the DCF method. The DCF method is a model used to value income-producing assets on a going-concern basis. It has intuitive appeal because it incorporates a risk/return perspective, which is critical to the investment decision process.

The DCF method estimates the value of a company by forecasting the company's expected future net cash flow and calculating the present value of that net cash flow by applying a risk-adjusted present value discount rate. The DFD method is a variation on the discounted cash flow ("DCF") method.

The DFD method follows the same procedures as the DCF method except that it measures the stream of expected distributions to the equity owners of the company.

Depending on the underlying inputs, the DCF and DFD methods can result in either a controlling interest or a noncontrolling interest indication of value. The resulting basis is influenced by the nature of the cash flow and the present value discount rate incorporated in the analysis.

In estimating a present value discount rate, the valuation analyst could apply a noncontrolling equity cost of capital to the expected distributions anticipated by the interest investor. That is, the expected rate of return a noncontrolling investor would demand for its passive interest in the art fund, understanding that return is generated over a long period of time due to distributions to the members after the sale of artwork.

The analyst may consider an orderly sale of the art portfolio and subsequent distribution of net proceeds to occur during the estimated investment holding period. The basis for these assumptions would be based on due diligence interviews of the art fund management.

In the DFD method analysis, the analyst projects the anticipated distributions to be made by the art fund to its investors over time and present values those anticipated distributions to the investors at a noncontrolling equity rate of return, or present value discount rate.

Projecting Future Fund Distributions

The first procedure in the DFD method is to develop reasonable projections of future distributions by the art fund to the art fund investors.

The projected future distributions are calculated as net proceed distributions to the members. Net proceeds are defined as sales proceeds, less commissions, less direct operating expenses (e.g., storage, insurance, maintenance expenses, debt service), and less a cash reserve for operating overhead (in this case, current cash holdings were deemed sufficient to cover operating expenses until dissolution).

In this case, net proceeds are sales proceeds less commissions, as operating expenses are anticipated to be covered by cash holdings throughout the term of the art fund.

Assumptions are made by the analyst regarding future income and future expenses of the fund. The analyst estimates:

1. the expenses to be incurred throughout the life of the fund and
2. the timing and sales of art net of transaction expenses.

These assumptions are often based on research, discussions with management, historical financial results, and information provided by the art appraisers.

Expenses for most art funds may include management fees, consignment fees, restoration costs, storage and security fees, insurance, accounting fees, legal fees, and other administrative expenses.

Unlike stocks and bonds, art prices tend to have a positive correlation with inflation. One of the greatest risks involved in art investment is that there is low transparency in the market. The art market is driven by the following key attributes: art is a heterogeneous asset, there is low market transparency, expertise is mainly in the hands of the seller, there is low liquidity in the market, and transaction costs are higher than in other markets.

Compared with other assets, the art market's drive to equilibrium is weaker; in the case of dead artists, supply is limited to those produced during their lifetime. Works of art are unique and cannot (on an individual basis) be substituted easily, and the equilibrium price is difficult to determine, so an objective evaluation is challenging to achieve.

One of the issues resulting from these factors is also a problem facing art as an investment: the question of its economic value. The price of art is as much an emotional value as it is an economic assessment and clearly reflects variations in supply and demand.

The highest price one is willing to pay is often attributed to a work of art as an indication of its relative attractiveness over time. Moreover, the value of an artwork stems from multiple factors. For example, art is tied to the increasing demand for artwork and increases in global wealth.

Yields on art are predominately derived from financial appreciation and surplus liquidity. Even in times of turmoil, economic downturn, and unattractive capital market trends, the art market has managed to survive.

While there can be large gains and losses occurring within short holding periods, returns during longer holdings periods are very close to zero, indicative of a random process with a mean of zero.[7]

Exhibit 1 summarizes some of historical trends in various classes of art as compared to the returns

Exhibit 1
Art Market Rates of Return by Investment Holding Period

	Latest 12-Month Return [a]	5-Year CAGR [b]	10-Year CAGR [c]	15-Year CAGR [d]
European Old Masters	2.21%	1.72%	1.72%	3.69%
Global Impressionist Art	10.50%	-0.78%	-2.07%	1.54%
Global Modern Art	3.62%	-2.50%	-2.43%	4.05%
Global Post-War Art	-0.98%	1.29%	-1.26%	7.12%
Global Contemporary Art	7.45%	4.09%	2.04%	8.54%
Fine Chinese Paintings and Calligraphy	0.67%	-0.59%	9.17%	11.50%
20th-Century and Contemporary Chinese Art	3.74%	1.10%	3.19%	14.10%
S&P 500 Index (SPX)	15.44%	11.93%	5.31%	10.43%
FTSE World Index (WI01)	12.79%	8.48%	2.22%	9.29%
MSCI Europe Index (MXEU)	7.82%	5.31%	-1.74%	6.57%
MSCI Asia Index (MXAS)	13.71%	7.51%	0.79%	8.55%

CAGR = Compound annual growth rate
[a] The lastest 12-month return is calculated from April 2016 to April 2017.
[b] The 5-year CAGR is calculated from August 2012 to August 2017.
[c] The 10-year CAGR is calculated from August 2007 to August 2017.
[d] The 15-year CAGR is calculated from August 2002 to August 2017.
Note: The returns presented above are nominal and do not include transaction fees.
Sources: *Art & Finance Report 2017* , Deloitte Luxembourg; ArtTactic; and S&P Capital IQ.

of various common stock indexes. This data is presented in the *Art & Finance Report 2017* and is sourced from Artnet art price indices.

In terms of the correlation across other asset classes, certain art categories, such as impressionism and old masters, are highly correlated with safe haven asset classes, such as bonds and real estate. Alternatively, riskier movements, such as contemporary and Chinese art, are more correlated with higher risk asset classes, such as stocks and commodities.[8]

Estimation of a Present Value Discount Rate

The second procedure in the DFD method is to estimate a present value discount rate that is appropriate for the art fund's future distributions to the investors. The appropriate discount rate is often a noncontrolling, illiquid investor rate of return.

Various art indices would suggest investors can reasonably expect an average annual return of nearly 9 percent on long-term holdings of investment-grade art. Such data is "fundamentally flawed," however, according to Arthur Korteweg, a financial economist with the University of Southern California Marshall School of Business and the lead author of a 2015 report called "Does It Pay to Invest in Art?"

The most popular art indices, including the Mei Moses Index, are based on repeat sales of artworks that have already demonstrated marketplace demand, notes Korteweg. "Sample selection bias has a first-order impact on art indices, lowering the average annual return by 28 percent, from 8.7 percent for a standard repeat sales index to 6.3 percent for selection-corrected indices," he writes, noting the risk-adjusted return, or Sharpe Ratio, also drops by nearly 60. "The implications are that an investor would not find it attractive to invest in a portfolio that is representative for the broad art market, unless she derives substantial nonmonetary utility from owning and enjoying art."

The Fine Art Fund Group chief executive officer Philip Hoffman notes that his funds have produced an average return of 9 percent before taxes (most art funds, including those offered by the Fine Art Fund Group, charge a 1 percent to 3 percent management fee, plus 20 percent of profits; however, the Fine Art Fund Group collects its commission only after its investors have earned at least a 6 percent return).

Hoffman notes that investors who opt for large, diversified art funds would be "very lucky" to get 10 percent to 15 percent returns.

"Somewhere in the 6 percent to 8 percent range is achievable with a well-managed, diversified fund. You can potentially earn double digits, but you would need to take on higher risk," stated Hoffman.[9]

In the *Artprice Contemporary Art Market: The Artprice Annual Report 2013*, Artprice notes that the financial returns on contemporary art today show that this segment is one of the best alternatives to traditional financial investments. On a sample

of nearly 1,000 contemporary works acquired at auction and subsequently resold at auction during the last 12 months, the average annual yield is 8.1 percent.

In a more recent interview between Deloitte Luxembourg and Madelaine D'Angelo of Arthena (a company that builds investment funds backed by art assets using quantitative strategies), "investments in post-war and contemporary art, for example, have generated 10.7 percent annualized reports over the past 20 years, with a standard deviation of 12.9 percent, while art funds have returned 8.8–12.5 percent on average.

The S&P 500 returned 8.3 percent in the same period, with 19.3 percent standard deviation."[10] Based on accessible publicly reported data, art fund investors generally demand a rate of return of about 10 percent per annum.[11]

Calculation of Net Distributions

The third procedure in the DFD method is to calculate future distributions. As an economic earnings measure, distributions of free net cash flow represent the maximum amount of cash which could be distributed to a company's equity holders without depleting normal operational cash requirements.

Present Value of Distributions

The fourth and final procedure in the DFD method is to calculate the present value of estimated future distributions.

The present value of the projected discrete period net cash flow is calculated by applying a present value discount factor to the projected net cash flow to be distributed to the equity investors. This factor is based directly on the previously calculated cost of equity capital and assumes that each year's net cash flow is received at year end by the investors.

The total present value of the discrete period distributions to the interest investor indicates the fair market value of the ownership interest.

Summary and Conclusion

Every valuation is unique, and each valuation is based on engagement-specific facts and circumstances.

Estimating the fair market value of an investment interest in an art fund is both complicated and intricate.

Analysts may apply one or more business valuation methods to estimate the value of a subject interest investor's stake in an art fund. Often illiquid and noncontrolling interests, the analyst considers an asset-based method and an income-based method. The analyst weights the value indications from each method based on the circumstances and the facts of the specific case.

Art fund investment interests transferred by gift during life or held by an estate at death often require both a qualified art appraisal and a qualified business valuation for tax reporting purposes.

These valuation analyses can assist the taxpayer in establishing "adequate disclosure" under the requirements set forth by the Internal Revenue Service in Regulation 301.6501(c)-1(f)(3) and meeting the "qualified appraisal" and "qualified appraiser" requirements set forth in Section 170(f)(11).

As art funds are established by high net worth individuals and families, and as collections are amassed over time, the valuation of these investments will become an important estate planning consideration of both taxpayers and their wealth advisers.

Notes:

1. "What Are Art Funds," The Art Fund Association LLC.
2. *Art & Finance Report 2017*, Deloitte Luxembourg and ArtTactic.
3. Shelly Schwartz, "Wealthy Investors Dabble in Art Investment Funds," CNBC.com (May 29, 2015).
4. "Cost of Your Art Collection: Appraisals and Art Insurance," Artwork Archive.
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6. Ibid., 191.
7. Raya Mamarbachi, Marc Day, and Giampiero Favato, "Evaluating Art as an Alternative Investment Asset," *Journal of Financial Transformation* 24 (2008).
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Kress v. United States of America—All Experts Consider Private Company's S Corporation Income Tax Status

Thomas M. Eichenblatt

This discussion considers the recent decision issued by the United States District Court of the Eastern Division of Wisconsin in Kress v. United States of America. *Specifically, this discussion describes (1) the main topics of the case and (2) the District Court's conclusion that the company's S corporation income tax status was merely a neutral factor in the valuation of a noncontrolling interest in the company common stock.*

Introduction

On June 24, 2016, James F. Kress and Julie Ann Kress (the "plaintiffs") sued the U.S. government, demanding a refund of the gift taxes and interest paid related to the plaintiff's series of gifts to their children and grandchildren of the noncontrolling stock (the "subject interests") of Green Bay Packaging, Inc. ("GBP"), an S corporation. The case, styled as *Kress v. U.S.*, was heard in the District Court of the Eastern Division of Wisconsin (the "District Court").[1]

The plaintiffs claimed that the subject interests were erroneously assessed by the Internal Revenue Service (the "Service") for the 2007, 2008, and 2009 tax years (the "disputed tax years"). The plaintiffs requested that the court decide the fair market value of the subject interests as of December 31, 2006; December 31, 2007; and December 31, 2008 (the "valuation dates"). A trial was held on August 3 and 4, 2017 (the "trial dates").

The judicial decision in *Kress v. U.S*. caught the attention of the valuation profession. That is because all valuation analysts in the case—both the taxpayer experts and the government expert—included quantitative and qualitative adjustments for the S corporation status of GBP when they estimated the fair market value of the subject interests.

The District Court decision, as well as the government's position in the case, recognize that there are income tax implications for S corporation entities—as compared to C corporation entities—that may be considered in a private company business valuation.

Background of the Case

GBP is a family-owned S corporation headquartered in Green Bay, Wisconsin. Founded in 1933, GBP is a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products. As of the trial dates, GBP employed approximately 3,400 people in 14 states.

As of the valuation dates, approximately 90 percent of the GBP shares of common stock were owned by the Kress family, and the remaining 10 percent were owned by the GBP employees and directors. Between 1990 and 2009, GBP paid annual dividends ranging from $15.6 million to $74.5 million to its shareholders.

According to the GBP bylaws, the purchase price for shares sold by GBP to its employees and directors is 120 percent of the book value of each share. For shares that are transferred to and from members of the Kress family, there is no legally binding buy-

sell agreement stipulated price. However, certain restrictions set forth in the GBP bylaws do limit the ability of a GBP shareholder to sell both family shares and nonfamily shares of GBP stock.

The right-of-first-refusal restriction contained in the GBP bylaws requires that an employee or director shareholder give GBP written notice of his or her intent to sell and offer to sell that share to GBP before selling that share to others (i.e., a right of first refusal).

The GBP bylaws also contain a family transfer restriction (the "family transfer restriction clause") that limits how the members of the Kress family may transfer their shares. The family transfer restriction clause states as follows:

> Transfer of shares of the Corporation by shareholders who are members of the Kress Family . . . is hereby restricted to transfers by gift, bequest or private sale to a member or members of the Kress family, provided, however, that the children of George and Marguerite Kress may transfer shares of the Corporation by gift to such child's spouse or trust therefor and further provided that in the event of any such transfer as above provided to issue and descendants or spouse of a child or trust therefor of George and Marguerite Kress, that all of the restrictions set forth herein shall continue to be applicable to the shares of common stock then held by such issue and descendants or spouse or trust therefor as transferee.

The family transfer restriction clause requires that the Kress family only gift, bequest, or sell their shares to other members of the Kress family.

The plaintiffs maintained that the family transfer restriction clause ensured that the Kress family retained control of GBP, minimized the risk of disruption to the GBP affairs by a dissident shareholder, ensured confidentiality of the GBP affairs, and ensured that all sales of GBP minority stock are to qualified S corporation shareholders.

As part of their respective estate planning procedures, most senior Kress family members would annually gift equal amounts of GBP stock to the younger members of their families, such as the plaintiffs. From 1997 to the trial dates, no junior member of the Kress family had gifted GBP shares to a more senior member of the Kress family, and there were no transfers of GBP shares between senior members of the Kress family.

The plaintiffs gifted noncontrolling blocks of GBP common stock to their children and grandchildren during the disputed tax years. The plaintiffs gifted common stock shares at the following share prices:

- Tax year 2007 – $28.00 per share
- Tax year 2008 – $25.90 per share
- Tax year 2009 – $21.60 per share

The plaintiffs each paid $1,219,241 in gift tax with respect to the gifted shares, for a combined amount of $2,438,482.

On November 10, 2010, the Service challenged the amounts reported by the plaintiffs on their gift tax returns. On August 19, 2014, the Service sent the plaintiffs a statutory notice of deficiency for each of the disputed tax years.

The Service found that the fair market value of the subject interests equaled the price used for actual share transactions between GBP and its employees, at the following share prices:

- Tax year 2007 – $45.97 per share
- Tax year 2008 – $47.63 per share
- Tax year 2009 – $50.85 per share

Exhibit 1 compares the original share prices and the share prices determined by the Service.

Exhibit 1
Fair Market Value of a Noncontrolling Share of GBP

Tax Year	Taxpayer Value ($)	Service Value ($)	Percentage Value Difference (%)
2007	28.00	45.97	64.18
2008	25.90	47.63	83.90
2009	21.60	50.85	135.42

As presented in Exhibit 1, the Service claimed that the actual fair market value of the subject interests were between 64.18 percent and 135.42 percent higher than the fair market value reported by the plaintiffs.

The plaintiffs paid the gift tax deficiencies and accrued interest in December of 2014, based on the Service audit findings, and then the plaintiffs filed amended gift tax returns for the disputed tax years seeking a refund for the additional federal taxes and interest they paid.

After six months without receiving a response from the Service, the plaintiffs initiated the *Kress v. U.S.* action on June 24, 2016.

Description of Green Bay Packaging, Inc.

The following information summarizes the GBP financial position during the disputed tax years.

GBP Balance Sheet Information

GBP had a strong balance sheet during the disputed tax years, with little debt compared to its recorded book value of equity. GBP had three nonoperating assets during the disputed tax years:

1. Hanging Valley Investments, LLC ("HVI")
2. Group life insurance policies
3. Two private airplanes

HVI is a wholly owned subsidiary of GBP that was created in 2005 to manage the GBP long-term investments. During the disputed tax years, HVI had investments in mezzanine financing obligations, private equity funds, real estate investment funds, gas, oil, and other commodities. HVI contributed capital to GBP through appreciation of—and sale proceeds from—these investments. GBP used these capital contributions for core operations and for paying dividends.

During the disputed tax years, HVI had the following asset values:

- Tax year 2007 – $65.0 million
- Tax year 2008 – $71.5 million
- Tax year 2009 – $77.3 million

GBP identified HVI as a nonoperating asset and its cash flow as nonoperating income.

The GBP group life insurance policies on key employees and shareholders had substantial cash surrender values. The cash surrender value of the GBP group life insurance policies, less the associated corporate liabilities of deferred compensation and nonqualified pension obligations during the disputed tax years, were as follows:

- Tax year 2007 – $86.0 million
- Tax year 2008 – $104.2 million
- Tax year 2009 – $111.4 million

GBP identified the cash surrender value of the life insurance as a nonoperating asset.

GBP owned two private aircraft during the disputed tax years. On average, the planes were used half of the time for GBP business and half of the time for the Kress family personal travel. The GBP cash flow projections categorized a portion of the aircraft as nonoperating income and expenses.

GBP Income Statement Information

From 2002 to 2008, the GBP net sales increased. The GBP net income increased overall from 2005 to 2008. In 2007, net income decreased by over $28 million, but increased in 2008 by $33 million. The decrease in net income was due to extraordinary costs incurred for maintaining a mill in Arkansas.

GBP management never considered terminating its S corporation status during the disputed tax years. During a management presentation in May of 2007, GBP management reported that they expected to save approximately $238.4 million in income taxes between 1988 and 2006 due to their S corporation tax status.

Valuation Analyst Opinions of the Fair Market Value of the Subject Interests

The plaintiffs engaged John Emory ("Emory") and Nancy Czaplinski ("Czaplinski") as testifying valuation analysts to opine on the fair market value of the subject interests as of the valuation dates. The government engaged Francis Burns ("Burns") as a testifying valuation analyst.

Each of the analyst opinions is discussed below.

Valuation Analysis by John Emory

Emory had been repeatedly engaged to prepare valuations for GBP since 1999. This history of prior valuation assignments included the valuations for the subject interests that were relied on by the plaintiffs in their original gift tax return filings.

Emory relied on the market approach for each of the valuation dates when estimating the fair market value of the subject interests. Emory did not rely on the income approach in his analyses.

Instead, he testified that the market approach was the better methodology to apply. That is because there were a sufficient number of comparable guideline publicly traded companies for each of the valuation dates.

Emory reviewed his prior GBP valuation reports, audited GBP financial statements, and projected GBP financial statements during each of his analyses. He also met with GBP management to discuss the current and future performance of GBP.

Emory selected five to six guideline publicly traded companies for each of the valuation dates. He then derived pricing multiples using a ratio of market value of invested capital to earnings before interest, taxes, depreciation, and amortization ("EBITDA"). By relying on pretax earnings metrics, Emory accounted for the GBP S corporation status.

Emory considered the nonoperating assets (previously discussed) to the extent that those assets contributed to the GBP earnings. He did not add their overall value back into the value of the subject interests, based on the premise that a noncontrolling shareholder in GBP could not realize the value of those assets.

Emory also accounted for the 2008 recession by excluding a guideline company for that year's analysis that was an outlier due in part to an acquisition.

Emory concluded his analysis by applying a discount for lack of marketability ("DLOM") to reflect the illiquidity of the subject interests.

Emory considered the following items in his selection of his DLOM:

- Restricted stock studies
- Pre-initial-public-offering studies
- The financial position of GBP as of the valuation dates
- The historical payment of dividends
- GBP's management expertise
- The possibility of any future initial public offering
- GBP's status as an S corporation

Emory did not quantify the effect of these factors on the selection of his DLOMs.

Emory stated that he also considered the family transfer restriction clause in his selection of DLOMs but noted that it did not have a significant effect on his final DLOM selections.

Emory applied a 30 percent DLOM for tax years 2007 and 2008, and a 28 percent DLOM for tax year 2009. His DLOMs were the highest of those used by the three experts in the case, but lower than the DLOMs applied in his previous work for GBP.

The Service took fault with Emory's lack of income approach analysis. In order to account for this, the plaintiffs engaged Czaplinski to prepare a valuation report for the subject interests as of the valuation dates using a combination of the market approach and the income approach.

Valuation Analysis by Nancy Czaplinski

Czaplinski estimated the following fair market values for the subject interests as of each of the valuation dates:

- Tax year 2007 – $30.87 per share
- Tax year 2008 – $25.92 per share
- Tax year 2009 – $25.06 per share

In contrast to Emory, Czaplinski applied both the market approach and the income approach in her analysis of the subject interests.

In the Czaplinski market approach analysis, she selected price-to-pretax income as the pricing multiple, and she used pretax income to capture:

1. the noncontrolling nature of the stock at issue,
2. the value of the nonoperating assets, and
3. the GBP S corporation status.

Czaplinski selected the lowest pricing multiple of the selected guideline publicly traded companies for each of the valuation dates due to the lower revenue and lower asset base of GBP compared to the selected comparable guideline publicly traded companies.

In the Czaplinski income approach analysis, she applied the capitalized economic income method and the discount dividend method. She accounted for the value of the nonoperating assets (previously discussed) by adding those values to the income approach method value indications.

In order to account for the GBP S corporation status in the capitalized economic income method, Czaplinski adjusted the discount rate in the base cost to reflect an equivalent after-corporate-tax

and after-personal-tax return. Under the discount dividend method, she applied a tax rate based on three- and five-year averages and on the prior year effective date.

Czaplinski applied a company-specific equity risk factor to the income approach calculations in order to account for the 2008 recession in her December 31, 2008, analysis.

Czaplinski weighted the market approach 14 percent and the income approach 86 percent when concluding her aggregate value for the subject interests as of each of the valuation dates. She then applied a DLOM of 20 percent for each of the valuation dates.

When selecting her DLOM adjustment, Czaplinski considered company and industry characteristics, including the family transfer restriction clause and the GBP S corporation status. She stated that neither the family transfer restriction clause or the S corporation status affected the DLOM selection.

Valuation Analysis by Francis Burns

The government retained Burns to estimate the fair market value of the subject interests as of the valuation dates. Burns concluded the following fair market values for the subject interests as of each of the valuation dates:

- Tax year 2007 – $38.40 per share
- Tax year 2008 – $27.81 per share
- Tax year 2009 – $40.05 per share

Burns estimated the fair market value by using both the market approach and the income approach.

In the Burns market approach analysis, he analyzed enterprise-value-to-EBITDA pricing multiples and price-to-earnings pricing multiples for comparable guideline publicly traded companies. After selecting and applying the multiples to the GBP financial data, Burns applied an S corporation tax premium to account for GBP's tax advantages as an S corporation.

He also added back the nonoperating assets to reach an indicated value of GBP common stock. Burns did not identify an adjustment in his analysis that accounted for the 2008 recession. That is because he considered GBP to be in good financial condition as compared to its creditors. He testified that he simply, "followed the numbers where they led him."

In the Burns income approach analysis, he applied a capitalized cash flow analysis instead of a discounted cash flow analysis because GBP did not prepare long-term financial projections. Burns determined a normalized level of income from operations. He then applied an effective C corporation income tax rate to GBP as if it were a C corporation, and then applied an adjustment to reflect the value of GBP as an S corporation.

His analysis also included a normalized level of capital expenditures, and he capitalized the earnings based on a perpetuity growth rate of 4.9 percent for each year.

He then added back the S corporation premium to account for the tax advantages associated with S corporation status. Burns also added back the value of the nonoperating assets previously discussed.

The Court's Opinion on the Valuation Reports

The District Court reviewed all the valuation reports and expert testimony in order to conclude the final value of the noncontrolling ownership interest.

The District Court found the valuation methods of Emory to be the most sound of the three experts. The Court found that Emory more adequately:

1. used projections that were more accurate due to his deep knowledge of GBP and
2. considered the effects of the recession of 2008.

The District Court concluded that Emory did not create his valuations with the benefit of hindsight or for the purposes of the litigation. The District Court found that Emory provided credible and thorough valuations that supported the fair market value of the subject interests that the plaintiffs reported on their original gift tax returns.

However, the District Court found that it was inappropriate of Emory to consider the family transfer restriction clause in his selection of DLOMs.

The District Court concluded that Burns overstated the value of the subject interests. The District Court took issue with the fact that Burns did not consider the effects of the 2008 recession and included an outlier comparable company in his market approach for the 2008 tax year. The court took issue with the fact that Burns only relied on two comparable companies for his market analysis, one of which was the outlier comparable company previously discussed.

The District Court also took issue with how Burns valued the nonoperating assets of GBP. In his analysis, Burns separated out the nonoperating assets and valued them separately, then added their value to the overall value of the operating company.

The court stated that a valuation analyst should only add back the value of the nonoperating assets

when valuing a controlling ownership interest in a company, not when valuing a noncontrolling ownership interest. This is because a noncontrolling ownership interest has no control over how the nonoperating assets are used and cannot realize the value of the assets until the company is sold.

The District Court also concluded that the Burns selection of DLOMs were unreasonably low. The court took issue with the fact that Burns applied lower discounts to GBP than he applied to a limited partnership that held marketable securities in a prior case, which the court considered to be a much more liquid investment compared to the subject interests.

Finally, the District Court took issue with the S corporation premium that Burns included in his analysis. Burns assessed a premium to account for the tax advantages associated with S corporation status, including single-level taxation. Both Emory and Czaplinski did not consider the GBP S corporation status to be a benefit that would add value to the subject interests because, in their opinions, a noncontrolling interest cannot change GBP's S corporation status.

The District Court found the GBP S corporation status to be a neutral consideration with respect to the valuation of its noncontrolling stock. The District Court recognized that there are also noted disadvantages of being an S corporation, such as the limited ability to reinvest in the company and the limited access to credit markets.

The District Court found it was unclear whether a noncontrolling interest holder enjoys those benefits.

The District Court rejected both the Service's value determined in the November 2010 audit, as well as the value estimated by the Service's expert, Burns. The District Court found that while it agreed with most of the Emory analysis, it disagreed with the DLOMs Emory applied. Therefore the court adjusted the DLOMs applied in the Emory analysis to be 27 percent in 2007 and 2008, and 25 percent for 2009. This was a 3 percent decrease in the DLOMs used by Emory. Exhibit 2 presents the values determined by each of the parties, as well as the final values selected by the Court.

Exhibit 2
Fair Market Value of a Noncontrolling Share of GBP
Summary of Opinions

Year	Emory	Czaplinski	Service	Burns	Court
2007	$28.00	$30.87	$38.04	$45.97	$29.20
2008	$25.90	$25.92	$27.81	$47.63	$27.01
2009	$21.60	$25.06	$40.05	$50.85	$22.50

Summary and Conclusion

The District Court concluded that Emory's original analysis provided the best fair market value indications for the subject interests as of the valuation dates. The District Court took issue with the Burns market approach due to his lack of consideration of the 2008 recession, his inclusion of the value of the nonoperating assets, and his low DLOM selections.

During this case, the District Court focused on how the analysts considered the effects of the 2008 recession, the consideration of the family transfer restriction clause, and the consideration of the GBP S corporation status. The District Court accepted Emory's analysis, which relied on pretax pricing multiples and DLOMs that considered the GBP S corporation status.

Additionally, the government relied on an expert witness who also incorporated qualitative and quantitative adjustments for the GBP S corporation status. The District Court did not find aspects of the Burns analysis to be as persuasive as the Emory analysis.

The subject interests in this case were a noncontrolling equity interest in GBP. The noncontrolling equity holder cannot change the company's S corporation income tax status. Accordingly, the District Court concluded that the GBP S corporation income tax status was merely a "neutral" factor in the gift tax valuation of the GBP noncontrolling common stock.

Note:

1. Kress v. United States, --- F.Supp.3d --- 2019 WL 1352944 (E.D. Wis. 2019).

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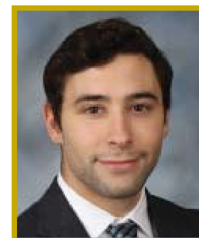


Damage Analyses in Claims regarding an Investment Management Trustee Breach of Fiduciary Duty

Connor J. Thurman, Jason M. Bolt, and Weston C. Kirk

The management of trust assets is often handled by a third-party trust fiduciary ("trustee"). Trustees have an obligation to manage trust assets with the intent of providing the best risk-adjusted outcome possible for trust beneficiaries based on the stated investment goals in the trust documents. In some situations, trustees can be accused of breaching their fiduciary duty to trust beneficiaries while managing the trust assets. Two types of claims typically made by dissatisfied trust beneficiaries are that (1) the trustee made overly aggressive investment decisions or (2) the trustee made overly conservative investment decisions. One part of either proving or disproving such trustee breach of fiduciary duty allegations while managing trust assets is the measurement of the damages (if any) that resulted from the claimed wrongful actions of the trustee. This discussion focuses on (1) investment management trustee fiduciary duties and (2) damage measurement methods that analysts may apply to conclude whether or not potential damages were incurred due to the alleged breach of fiduciary duty.

Introduction

This discussion addresses investment management decisions made by trustees who hold a fiduciary responsibility to trust beneficiaries. That is, this discussion considers a trustee (whether a corporate trustee or an individual trustee) that makes investment management decisions on behalf of a trust.

Although not all trustees are directed by the trust agreement to be an investment manager trustee (as such rights may be delegated to the donor, beneficiary, or an independent third party), most allegations of mismanagement of trust assets are claimed against an individual or corporate trustee that has the fiduciary duty to manage the investments (or assets) of the trust.

This discussion summarizes the role of the investment management trustee, the fiduciary duties held by the investment management trustee, the typically asserted claims against investment management trustees, and the damages measurement analyses applied to determine whether or not potential damages were incurred due to alleged breaches of fiduciary duty.

Fiduciaries and Fiduciary Duty

A fiduciary relationship is one in which one party (or entity) holds a legal and/or ethical relationship of trust with another party (or group). Trust fiduciaries fall into this category when managing assets and investments held in trust. Trustees generally have power over the assets of the trust.

The trustee is under a legal obligation to:

- put the trust beneficiary's interest first,
- avoid potential conflicts of interest, and
- not personally profit without both the beneficiary's knowledge and consent.

Fiduciary duty is the standard to which a fiduciary is held when managing the assets of a beneficiary. The Legal Information Institute at Cornell Law School sets forth the following definitions:

> A fiduciary duty is the highest standard of care. The party who has a fiduciary duty is called the fiduciary, and the person to whom they owe the duty, is typically referred to as the principal or the beneficiary. If a fiduciary breaches their fiduciary duties, they would need to account for any and all ill-gotten profit. The beneficiaries who are owed the fiduciary duty are then entitled to damages, even if they suffered no harm.[1]
>
> The trustee is the party who holds legal title to the trust property. The trustee may also be the trust beneficiary, but he may not be the sole beneficiary because then there would be no separation between legal and equitable ownership, which is required for a valid trust. A trustee is a requirement of an express trust along with trust property, trust intent, and definite beneficiaries.[2]

The role of a trustee is to serve as a fiduciary of the trust assets, but the role can also include administrative duties. The risk of the trustee not satisfying its fiduciary duty to the beneficiaries is lower with respect to the trustee's administrative duties and greater with respect to the trustee's power to make investments of trust assets.

The roles and duties of the trustee may include (but are not limited to) the following:

1. Review and understand the trust document
2. Administer the trust according to the trust terms
3. Prepare records, forms, statements, and tax returns
4. Communicate with beneficiaries
5. Distribute trust assets, if and when applicable
6. Invest and manage trust assets

The following sections discuss the procedures involved in managing trust assets and breach of fiduciary duty claims that may arise.

Trust Investment Objectives and Policies

One important procedure in the process of administering a trust or acting as a trust fiduciary is the creation of an investment policy statement ("IPS"). An IPS is a legal document required when implementing an investment strategy on behalf of a trust. An IPS may act as a blueprint for investment strategy and a score card for measuring investment performance.

There are usually specific questions that may be identified within an IPS that can guide trustees when they make investment decisions for trusts. These questions may include the following:

- What assets does the trust currently hold?
- What percentage of the trust assets may be invested in any current period?
- How long will these assets be invested?
- What are the expectations for investment returns (net of inflation) each year for these trust assets?
- How much of a loss can be recognized over a short, medium, and long-term period?
- What (if any) is the target asset allocation of the trust assets, and what (if any) is the risk tolerance of the trust beneficiary?
- What (if any) is the trust assets' ability to be diversified?
- What are the benchmarks or performance indicators used to measure trust investment performance?

An IPS may be helpful in outlining the specific objectives of the trust assets. The trustee(s) and trust beneficiaries may want to create specific target objectives for the investment period. These objectives may relate to the following:

1. Maximizing financial returns
2. Minimizing financial losses
3. Achieving steady long-term growth
4. Providing for liquidity
5. Other desired outcomes (such as following an environmental, social, and governance strategy)

When creating the IPS, the objectives may be made with constraints in mind, such as a large holding in a family-owned public or private company. In some situations, while diversification may be the most appropriate strategy, the trustee may be barred from reducing certain core holdings.

Depending on the goals and objectives of the investment of trust assets, the trustees and beneficiaries, may need to establish:

1. the desired financial goals,
2. the duration of the investment(s), and
3. the acceptable cost of investing trust assets.

Investment Philosophy

A trustee may also require an IPS to include the overall investment philosophy of the trust to determine the proper investment strategy. Some issues to consider when determining the investment philosophy outlined in an IPS may include the following:

- Overall investment objective
- Risk tolerance and risk management
- Traditional versus nontraditional investments
- Asset allocation strategy
- Frequency of trading activity
- Limitations on investment costs
- Tax management strategies
- Provide for sufficient liquidity for required distributions, if any, and lifestyle spending

These issues may help a trustee to select an investment strategy that best addresses the desired investment outcomes of trust assets. The individual trust should not necessarily be considered as a stand-alone trust, but be taken in the context of the beneficiaries' portfolio as a whole.

Challenges may arise when beneficiaries have different total portfolios or different risk tolerances. A qualified investment adviser may assist the trustee with solving these issues.

Investor Risk Tolerance

When administering a trust or acting as a fiduciary over trust assets, it is often required to properly understand the risk tolerance of the beneficiaries whose assets are being managed.

If the trustee of the trust assets does not properly assess the level of risk that investors (i.e., the trust beneficiaries) are willing to accept, issues may arise due to the disconnect of investment expectations and actual investment outcomes.

Assessing the risk tolerance of the beneficiaries includes discussing the risks and returns of holding a concentrated or undiversified portfolio if that is the desire of the beneficiaries.

Investor risk tolerance can be thought of as the level of uncertainty that a particular investor (or group of investors) is willing to accept. In general, the higher level of uncertainty (or risk) that an investment has associated with it, the higher level of return will be required. When a trustee is administering a trust, the trustee must determine what level of uncertainty (or risk) that the investors are willing to accept.

According to the U.S. Securities and Exchange Commission:

> In general, an aggressive investor is one with high risk tolerance and is willing to risk losing money in order to potentially achieve better results and higher returns for their investment. In contrast, a conservative investor is one with low risk tolerance who may likely favor investments that protect their original investment (or grow it slowly).[3]

Determining the risk tolerance of an investor(s) is often a function of the following:

1. Investment time horizon
2. Desired return on invested assets
3. Future earning capacity (or alternate sources of income)
4. Presence of other assets (such as a home, pension, or inheritance)

A trustee should consider all of these factors as they relate to the trust beneficiaries whose assets are being managed.

Investor Goals and Objectives

The complement to risk tolerance is expected or required return. A trustee should understand the specific objectives of the beneficiaries whom they represent with regards to the trust assets being invested and what level of return is necessary to achieve those goals. For instance, if trust assets are sufficiently large to fund ongoing living expenses and distributions, and the goal is to maintain a standard of living, a relatively low risk, low return strategy may be appropriate.

Alternatively, the beneficiaries may express an interest in capital appreciation, in which case, a higher risk, higher return strategy may be appropriate.

However, if spending is outpacing the growth in assets, the trustee should communicate with the beneficiaries regarding how much additional return is required to maintain or increase the value of trust assets and what additional risk is required or what reductions in spending will be necessary to achieve the beneficiaries returns given a certain level of risk.

In the context of asset management for the beneficiaries of a trust, the trustee's goals and objectives may fall into one of three categories:

1. Income generation
2. Growth and income
3. Asset growth

In addition to income and growth objectives, risk tolerance and risk management are important considerations.

Exhibit 1 presents a summary of potential investors' objectives and risk tolerance.

Investment Performance Benchmarking and Measurement

When managing trust assets, a trustee may continually monitor and measure the performance of the trust's investments to ensure that the desired goals and objectives are being met.

According to *Performance Measurement: The What, Why, and How of the Investment Management Process*, investment performance measurement is a four-step process that entails the following:[4]

- Benchmarking
- Calculating the portfolio's excess return
- Performance attribution analysis
- Risk analysis

Benchmarking

The performance measurement process requires that the trustee selects an appropriate benchmark to assess the performance of trust assets. Ideally, that benchmark will be:

1. investable,

Exhibit 1
Investor Risk Tolerance and Investment Objectives

	Risk Tolerance	Low	Moderate	High
Objective	Income	Conservative income investors favor low risk strategies at the expense of returns. Low duration bond funds, short-term Treasury bonds, or short-term high-quality corporate debt will typically be a significant portion of the portfolio. Dividend paying equities may be included as well, but equities will comprise a small portion of the portfolio.	Moderate income investors favor a balanced portfolio while still focusing on current income. A combination of equities and fixed income are typically used in the account. High-quality fixed income will still be sought; the duration of the bond portfolio may increase to achieve higher returns. Additionally, equities may comprise a portion of the portfolio.	Aggressive income investors favor maximizing current returns while accepting high risk. These investors may use more aggressive strategies that may offer higher potential returns. Preferred equities, high dividend paying equities, corporate debt, high-yield debt, and derivative strategies may all be considered as possible investments.
	Growth & Income	Growth and income investors with low risk tolerance seek current income balanced somewhat with capital appreciation. They are willing to accept lower potential returns in exchange for a lower risk investment. Fixed income will be a significant portion of the portfolio, but an allocation to dividend-paying equities will be expected.	Investors seeking some current income and long-term growth may increase their returns (and risk) by incorporating a larger portion of dividend-paying and non-dividend-paying equities and reducing exposure to fixed income. Risk of losing principal increases, but so, too, does the expected return.	Investors with a high risk tolerance seeking both growth and current income may invest in a combination of fixed income, equities, and derivatives. Fixed income may be a relatively small portion of the high risk portfolio. A long-term time horizon is necessary to allow more aggressive strategies with the opportunity to earn higher potential returns.
	Growth	Conservative growth investors seek to maximize capital appreciation while focusing on low risk strategies. Investors in this category are willing to accept lower potential returns in exchange for lower risk. The time horizon is often intermediate. Equities of large capitalization companies in developed markets will typically be a significant portion of the account, and some fixed income will be considered.	Investors seeking capital appreciation with moderate risk may focus on large capitalization equities in developed countries and may also consider smaller capitalization equities or equities from emerging markets.	Investors with a high risk tolerance seeking growth typically have a long-term time horizon, allowing the investor to pursue higher risk with more aggressive strategies that may offer higher potential returns over time. Equities may be as much as 100 percent of the account and may have increased allocations to small capitalization equities from both developed and emerging markets. Depending on the size of the investment assets, alternative investments (such as private equity) and hedge funds may be appropriate.

2. accessible,
3. independent, and
4. relevant.

As a standard, benchmarks can be based on market indexes (e.g., Standard & Poor's 500, Wilshire 5000), peer groups (a portfolio that contains the same or similar type of assets in the trust), or based on specific targeted returns (e.g., the risk-free rate, inflation plus funding requirements).

Calculating the Excess Return

The excess return on an investment or pool of investments and its benchmark's return can be calculated arithmetically or geometrically, as presented in Figure 1.[5]

Arithmetic excess return is generally more common due to the fact that it (1) is easier to understand and (2) provides large and absolute values in rising markets. However, geometric return may be more appropriate when measuring excess returns over multiple periods, in different currencies, or when comparing returns.

Alternatively, when the initial value of the portfolio assets differs from the initial value of the assets of the benchmark, excess returns can be simply calculated as the difference of returns of the portfolio and the benchmark. This calculation is presented in Figure 2.

Performance Attribution Analysis

According to *Performance Measurement: The What, Why, and How of the Investment Management Process*, performance attribution quantifies:

> [t]he relationship between a portfolio's excess returns and the active decisions of the portfolio manager. In other words, it relates the excess returns of the portfolio (both positive and negative) to the active investment decisions of its manager (or trustee). It provides feedback to portfolio managers, senior management, and external consultants on why the portfolio either outperformed or underperformed its benchmark.

Further, the following list presents three types of performance attribution:

- Returns-based attribution, which uses factor analysis
- Holdings-based attribution, which is calculated periodically and uses holdings data
- Transactions-based attribution, which is calculated from holdings and transactions data

Performance attribution analysis is an important component of managing invested assets as the analysis can help determine whether investment performance is due to the asset manager or the investment adviser.

Risk Analysis

According to *Performance Measurement: The What, Why, and How of the Investment Management Process*, basic risk measures can be divided into the following categories:

- Absolute risk measures, such as standard deviation
- Relative risk measures, such as tracking error
- Regression, which measures the alpha, beta, and standard error of the portfolio's return

When evaluating the investment performance of trust assets, a trustee may wish to consider all of the preceding items in order to ensure that they adequately adhere to the fiduciary duty entitled to trust beneficiaries.

Figure 1
Arithmetic Excess Return versus Geometric Excess Return

$$\text{Arithmetic Excess Return} = \frac{\text{End Portfolio Value - End Benchmark Value}}{\text{Initial Portfolio Value}} \times 100 \text{ Percent}$$

$$\text{Geometric Excess Return} = \frac{\text{End Portfolio Value - End Benchmark Value}}{\text{Initial Benchmark Value}} \times 100 \text{ Percent}$$

Figure 2
Excess Return Calculation

$$\text{Excess Return} = \frac{\text{End Portfolio Value - Initial Portfolio Value}}{\text{Initial Portfolio Value}} - \frac{\text{End Benchmark Value - Initial Benchmark Value}}{\text{Initial Benchmark Value}}$$

Damages Analyses Related to Allegations of Investment Management Trustee Breach of Fiduciary Duties

A damages measurement analysis is informed by a number of legal standards that should be met to support the damages claim. Legal standards are usually addressed in a later stage of the lawsuit.[6] However, if the facts and circumstances of the lawsuit do not satisfy these legal standards, while the lawsuit may be valid in terms of the defendant's performance of a wrongful act, the plaintiff may not be eligible to receive any pecuniary relief.

Prior to filing the judicial action, the plaintiff's counsel will evaluate the lawsuit based on the merits of addressing these legal standards.

Assuming the legal standards are met, to quantify a breach of fiduciary duty damages measurement for the trier of fact, an analyst can apply generally accepted damages methods.

Allegation of Investment Trustee Breach of Fiduciary Duties

Allegations of a breach of fiduciary duty occur from time to time. These allegations are typically due to an actual or realized loss of investment principal and are typically coupled with other allegations of malfeasance.

Remedies sought by the plaintiff/claimant in litigation vary depending on the severity of the alleged breach of fiduciary duty. In instances where a suit is brought alleging mismanagement of assets due to a lack of diversification or selecting investments inappropriate for the trust, damages are typically limited to the recovery of principal lost due to the trustee's actions.

However, in instances where allegations are brought due to fraud, conflict of interest, self-dealing or other misconduct, damages may not be limited only to the recovery of principal.

The following sections discuss four generally accepted damages methods that analysts may consider when measuring damages related to allegations of investment trustee breach of fiduciary duty with regard to investments.

Damages Measurement Approaches and Methods

In the case of allegations against investment management trustees for either overly aggressive or overly conservative investment strategy, the measurement of damages may be measured by applying one of the following:

1. Ex-ante damages measurement methods
2. Ex-post damages measurement methods

In an ex-ante damages measurement, lost profits are discounted at a risk-adjusted rate from the terminal date to the date of the alleged wrongful acts. The analyst may then add interest damages from the date of the alleged wrongful acts to the date of the trial based on the prejudgment interest rate.

Ex-ante damages measurements typically consider only information that was known or knowable as of the date of the alleged breach of fiduciary duty.

In an ex-post damages measurement, the analyst discounts future lost profits (from the current date to the terminal date) back to the current date based on a risk-adjusted rate. For historical lost profits, the analyst does not apply a discount rate, but instead totals the undiscounted lost profits from the date of breach through the current date.

Ex-post damages measurements rely on all information available as of the date of trial.

If the damages award is taxable to the plaintiff, it may be appropriate to recommend to the court that the total damages award include both the after-tax damages measurement and the income tax expense related to the damages measurement.

There are several generally accepted methods to measure damages in a trustee breach of fiduciary tort claim. While these measurement methods are often applied to quantify lost profits economic damages for business operations, they can also be tailored to effectively analyze and quantify investment management damages as a result of a trustee breach of fiduciary duty.

Lost Profits Damages

One damages measurement method is the lost profits method. The lost profits method quantifies the additional profits (above actual profits) that the plaintiff would have achieved but for the wrongful act of the defendant.[7]

Sales Projection Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the projection method is described as follows:

> The sales projection method utilizes company-specific forecasts for certain items, preferably by using forecasts that the company has prepared in the ordinary course of business or for some other purpose other than the litigation. Some business are more sophisticated than others, and their projections (formatted like a typical income or operating statement) may specify revenues by product lines, detailed expenses, income taxes, and miscellaneous income/expenses.[8]

Many courts have concluded that the projection method for calculating damages is reliable. However, as presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*:

> [T]he challenge for the financial expert remains not to make the appropriate estimates and analyses and then relate them to the performance that the specific event impacted so the conclusions are reliable.[9]

Before-and-After Method

In the before-and-after method, analysts may compare:

1. income from the time period in which profitability was affected by the alleged damaging acts (the "damage period") to
2. results attained prior to or after the damage period (the "comparison period").

If performed correctly, this measurement method allows the analyst to identify lost profits resulting from the alleged breach of fiduciary duty.

In order to apply this measurement method, the analyst should identify and quantify the effects of all other factors that may affect profitability in either the damage period or the comparison period.

For example, if the analyst measures damages for a trust by comparing returns from the 2009 to 2010 damage period with income from the 2005 to 2008 comparison period, the analyst should also consider the impact of the decline in returns during the damage period.

The reliability of the before-and-after method may be reduced to the extent that adjustments have to be made for the results of additional external factors.

Another potential limitation of the before-and-after method may be the availability of data. The before-and-after method requires operating data for the analyst to identify meaningful returns from the damage period and the comparison period.

These data may not always be available due to factors such as a limited investment history, challenges identifying or clarifying a distinct damage period, and other factors.

"But-For" Portfolio Analysis

A "but-for" investment portfolio is a technical term. A "but-for" investment portfolio is a tool that may be applied to measure certain types of damages in certain types of disputes.

A "but-for" investment portfolio is a hypothetical alternative investment portfolio that is modeled and then compared to an actual investment portfolio.

The analyst may construct the "but-for" investment portfolio to estimate the value of the investment portfolio "but for," say, an alleged trustee breach of fiduciary duty.

Damages may be measured by subtracting:

1. the ending value of the actual trust investment portfolio (i.e., the actual portfolio that suffered from the alleged breach of fiduciary duty) from
2. the ending value of the "but-for" trust investment portfolio.

Of course, such a measure of damages only considers one investment metric: return.

So, the "but-for" portfolio analysis only measures incremental return (the "but-for" portfolio compared to the actual portfolio). A complete measure of damages also has to measure the other investment metric: risk. Therefore, the "but-for" portfolio damages analysis is not complete unless it measures both of the following:

1. Incremental return
2. Incremental risk

Two methods incorporating the "but-for" portfolio analysis are the following:

1. The yardstick method
2. The market model method

Yardstick Method

In the yardstick method, the analyst compares the performance of the subject trust assets to benchmark data from the same time period. As previously discussed, the benchmark data may be the investment performance of market indexes, investment peer groups, or targeted returns that were unaffected by the alleged wrongful acts.

In order to correctly apply this method, the analyst should select benchmark data that are

sufficiently similar to the subject portfolio of assets. The credibility of results from the yardstick method may be reduced to the extent that benchmark data are dissimilar to the subject portfolio of assets.

The analyst may consider qualitative and quantitative similarities between the subject portfolio of assets and the benchmark data. Regression analysis is a useful tool to analyze quantitative similarities. For example, an analyst could perform a regression analysis to compare the subject portfolio of assets returns to peer group returns over a certain number of years.

The analyst should also consider any other changes in the subject portfolio of assets that may have affected the performance of the subject portfolio of assets relative to the benchmark data over the period reviewed (e.g., changes in asset management, changes in trust asset composition).

Market Model Method

As presented in the *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the market model method is described as follows:

> The fourth methodology for determining lost profits, the market model, is not used as often as the first three models already discussed. According to this methodology, the expert considers the plaintiff's market share prior to the defendant's alleged act to determine lost revenue/sales. For example, in a market in which the plaintiff and defendant are sole competitors, the plaintiff needs only to show "evidence defining the market, demonstrating what share of the market would have been but for the defendant's breach, and establishing the profit he would have earned on the increased sales."[10]

While this measurement method is sometimes applied in patent infringement matters, it may be applied in other damages scenarios resulting from allegations of overly conservative or overly aggressive investment strategy, if appropriate data are available.

Illustrative Example of the Before-and-After Method

In fiduciary tort cases related to overly aggressive or overly conservative investment practices, the before-and-after method is often considered and applied in damages measurement analyses.

Overly Aggressive Practices

Overly aggressive investment advisory and management can arise from a trustee or adviser selecting investments that violate the risk tolerance of the beneficiary, selecting assets inappropriate in the context of the portfolio as a whole, implementing an asset allocation inappropriate for the age of the beneficiary, and/or other high-risk trading and investing strategies.

In the case of *Honea v. Raymond James Financial Services, Inc.* ("RJFS"), Honea argued that RJFS breached its fiduciary duty and breached its contract, among other allegations. While the case dealt with numerous legal and procedural challenges, the initial claim brought to the court stemmed from a significant loss of principal by Honea.

Honea "alleged that RJFS engaged in 'abusive brokerage practices' in that her investments were not diversified, 'were far too risky,' and 'were of poor quality.'"

Honea claimed that due to the actions of RJFS, she lost nearly 90 percent of her initial principal balance as RJFS aggressively invested in options and used margin.

The arbitration panel found that the adviser did not make sufficient effort to know his client nor did he understand her investment experience. The arbitration panel found that these failures contributed to losses in Honea's account.

While the case is ongoing, the trial court entered in favor of Honea recouping her losses. Based on account statements provided, it was clear to the trial court when funds were deposited, when investments occurred, and when the resulting losses occurred.

In the RJFS case, a ruling was made in favor of Honea to recoup her losses of principal. Alternatively, it could have been argued that due to the poor management of Honea's investment assets, her losses were (1) actual loss of principal and (2) hypothetical losses of incremental returns from a reasonably managed investment portfolio.

The basic facts of the case are as follows:

- Starting in 1997, Honea opened several accounts and deposited various amounts into those accounts.
- The total amount deposited as of March 30, 2006, was approximately $1.2 million.
- Honea claimed that as a result of the actions of Raymond James, losses of $1.05 million were incurred.
- Honea did not have extensive investing experience.

Based on the foregoing, and to further the illustrative example, we make the following additional assumptions:

- The investment returns sought are assumed to be moderate with a moderate level of risk.
- The account is a taxable account, but for simplicity, a tax-aware strategy was not considered.
- All returns are pretax returns.
- The time horizon is long term.

We further assumed the investment start date was January 1, 1997, and even though funds were deposited over a period of time, we assumed the full $1.2 million was deposited on that date. We based our hypothetical analysis on potential returns that could have been earned from January 1, 1997, to March 30, 2006, based on a moderate asset allocation.

As mentioned previously, a moderate risk portfolio seeking growth and income may incorporate both equities and fixed income.

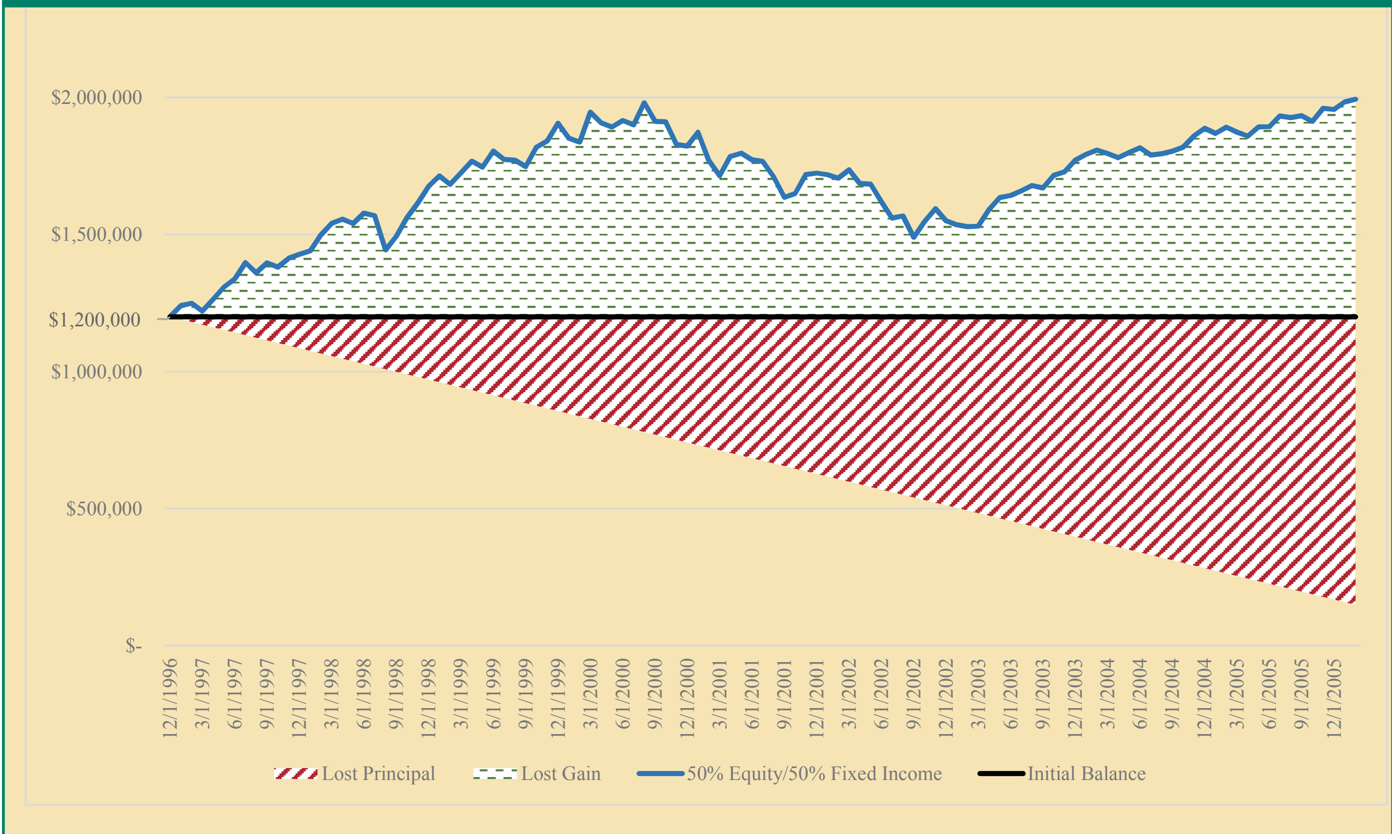
A reasonable portfolio allocation in this hypothetical case could be in the range of 30 percent to 70 percent fixed income allocation and 30 percent to 70 percent equity allocation. Using actual returns for an investment in a 10-year Treasury bond and actual U.S. equity market returns, we estimated portfolio returns of approximately $800,000, depending on the asset mix. Thus, total damages could be represented as the loss of principal of $1.05 million and the opportunity cost of the unearned gain of approximately $800,000 for total damages, or total damages of $1.85 million.

Figure 3 illustrates the losses incurred (assuming a linear decline in account balance) and the opportunity cost of the lost gains assuming various asset allocations.

Overly Conservative Practices

In cases of overly aggressive investing, the allegations will typically revolve around actual losses incurred and the opportunity cost of returns. Overly conservative investing, on the other hand, will typically only focus on the opportunity cost of not implementing a certain strategy.

Figure 3
Illustration of Damages Resulting from an Overly Aggressive Investment Strategy



In the case of a breach of fiduciary duty where the allegation is the assets were managed too conservatively, the allegations will likely focus on a portion of the IPS stipulating some level of expected or desired return on trust assets.

While every situation is different, a common targeted return is a level sufficient to support a reasonable amount of spending (typically about 3 percent of assets) plus inflation as measured by the consumer price index ("CPI") or the personal consumption and expenditures price ("PCE") index.

If we assume the same facts and circumstances as the RJFS case in our hypothetical damages example, but we assume the asset manager did not follow the agreed on IPS stipulating a return sufficient to maintain purchasing power, the damages analysis would change somewhat.

Let's assume the IPS stipulates that assets must increase at a sufficient rate to maintain purchasing power only. In this case, the assets need to grow in line with either the CPI or the PCE index (historically, about 2 percent to 3 percent per year). In this case, the trustee may consult with an outside adviser to determine an appropriate investment strategy.

The trustee may be accused of following an overly conservative investment policy if the trustee:

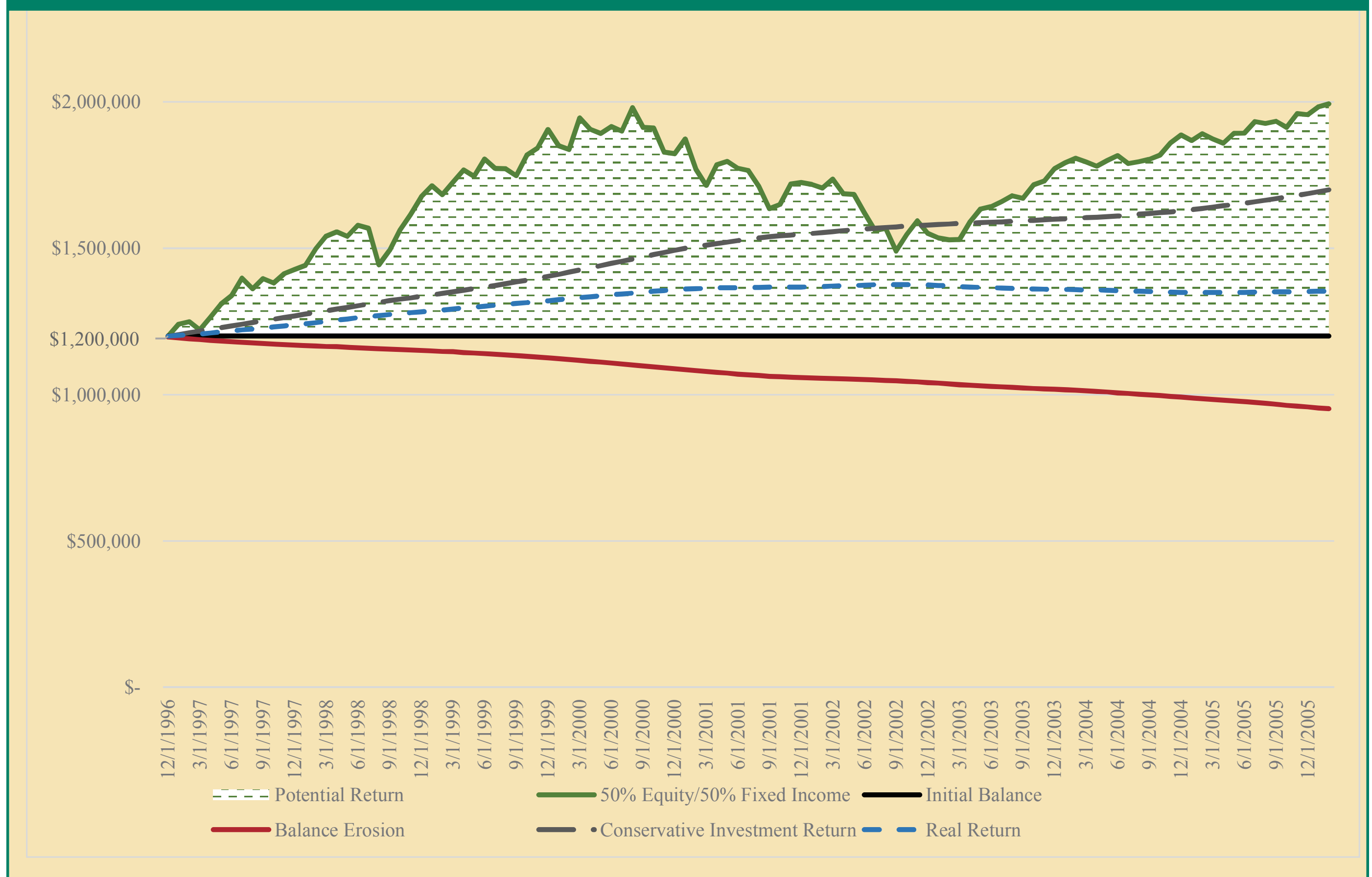
1. receives poor advice or
2. does not seek any advice and
3. invests in a low risk asset or
4. does not invest the assets at all and earns a correspondingly low return (such as a money market fund).

Assuming the same initial funds and start date as the RJFS case, we can illustrate the opportunity cost of funds being invested in an overly conservative manner.

Assuming the funds are uninvested and earn no or low returns, the purchasing power of the initial balance is eroded by inflation. However, if the funds are invested in low risk assets, purchasing power can be maintained as presented in Figure 4.

As can be seen in Figure 4, by leaving the funds uninvested, inflation erodes the purchasing power

Figure 4
Illustration of Damages Resulting from an Overly Conservative Investment Strategy



over the time period. However, even with a low-risk investment strategy, the purchasing power can be protected.

Total damages in the illustrative example in the case of overly conservative investment management can be thought of as:

1. the loss of purchasing power and
2. the opportunity cost of unearned real capital appreciation.[11]

In this case, the assumed beginning balance was $1.2 million, but at the end of 10 years, inflation would have eroded the purchasing power to $900,000. In addition, investing conservatively in a risk-free bond[12] would have provided a return of approximately $750,000, or 3.8 percent annually.

In real terms (that is, deducting inflation from the return), purchasing power would have hypothetically improved somewhat, providing a real return of approximately $165,000 over the investment period.

In this hypothetical example, the damages are both of the following:

1. Lost purchasing power of approximately $300,000
2. Lost opportunity cost of real investment returns of $165,000

The sum of these two measurements indicates total damages of approximately $465,000.

Summary and Conclusion

This discussion provided a general overview of, and addressed various issues pertaining to, claims of breach of fiduciary duty due to overly aggressive or overly conservative investment strategy employed by investment management trustees.

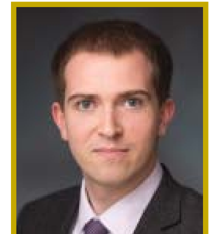
Further, this discussion presented various metrics and methods of analyzing both:

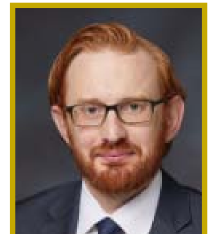
1. the validity of breach of fiduciary duty claims and
2. any potential damages that may have resulted if such a breach is found to have occurred.

Both trustees and analysts should consider the information in this discussion in order to understand the potential for breach of fiduciary duty claims resulting from overly aggressive or overly conservative investment strategies employed by trustees and any potential damages resulting from said alleged breach.

Notes:

1. Definition of "fiduciary duty" by Cornell Law School Legal Information Institute.
2. Definition of "trustee" by Cornell Law School Legal Information Institute.
3. "Assessing your risk tolerance," U.S. Securities and Exchange Commission, www.investor.gov [accessed on March 14, 2019].
4. Michael McMillan, "Performance Measurement: The What, Why, and How of the Investment Management Process," Enterprising Investor Blog (June 1, 2012), www.blogs.cfainstitute.org.
5. Note that this assumes the initial value of the subject portfolio of assets is the same as the benchmark.
6. Fady F. Bebawy, "A Primer on the Fundamental Elements of Economic Damages Analysis," Willamette Management Associates *Insights* (Summer 2018): 3–14.
7. Ibid., 11.
8. Nancy J. Fannon and Jonathan M. Dunitz, *The Comprehensive Guide to Lost Profits and Other Commercial Damages* (Portland, OR: Business Valuation Resources, 2014), 223.
9. Ibid., 225.
10. Ibid., 226.
11. Real capital appreciation is the difference between nominal returns (the rate of return calculated by comparing the ending balance to the beginning balance) and the inflation rate.
12. Assuming reinvestment of coupon payments monthly at the then-prevailing interest rate and all bonds held to maturity (i.e., no price appreciation or depreciation is realized).





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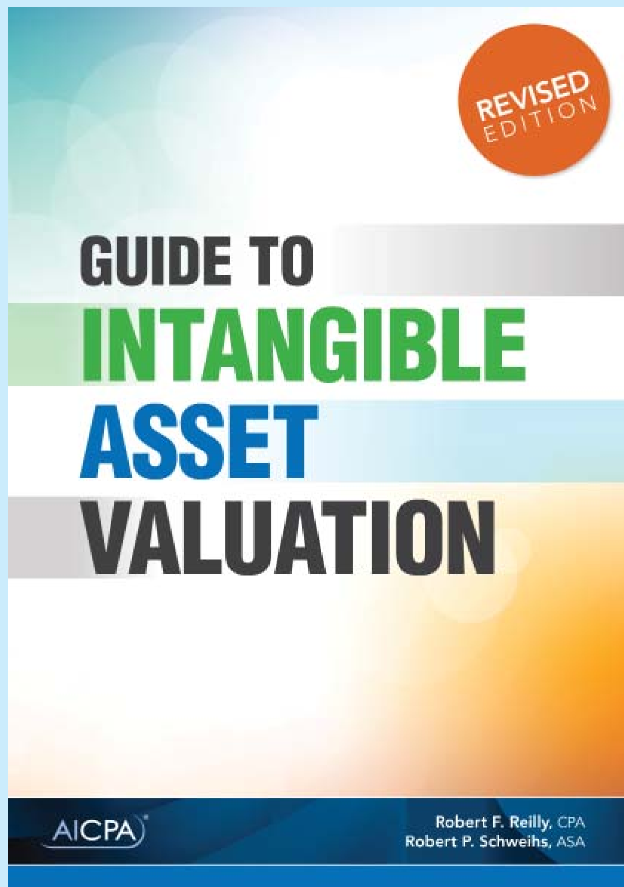
We are pleased to announce the Revised Edition of . . .

Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

Illustrative examples are provided throughout the book, and detailed examples are presented for each generally accepted (cost, market, and income) valuation approach.

Who Would Benefit from This Book

- Litigation counsel involved in tort or breach of contract matters
- Intellectual property counsel
- International tax practitioners
- Property tax practitioners
- Auditors and accountants
- Valuation analysts
- Licensing executives
- Multinational corporation executives
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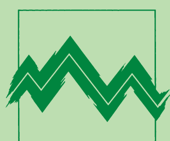
- Judges and arbitrators



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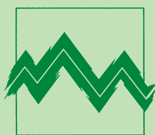

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What Tax Counsel Needs to Know about Working with a Valuation Specialist

Robert F. Reilly, CPA

Tax counsel often have to retain, and work with, a valuation specialist related to a gift tax, estate tax, or generation-skipping transfer tax controversy. This statement is particularly true if the transfer involves a private company, a private business ownership interest, a closely held security, or an intangible asset. This discussion provides guidance to tax counsel related to selecting, working with, and defending the work of the valuation specialist.

Introduction

The value of a private company, company ownership interest, security, or intangible asset is often an issue in gift tax, estate tax, generation-skipping transfer tax, and other transfer tax matters. These issues may arise in a tax planning, tax compliance, or tax controversy context. In such instances, the taxpayer or the taxpayer's tax adviser may retain a "valuation specialist" (or "specialist") to develop—and report on—the value of the subject business interest.

This discussion focuses on valuation-related tax controversies. And this discussion assumes that tax counsel is assisting the taxpayer (e.g., a private company owner/operator) with the tax controversy matter. Therefore, this discussion assumes that tax counsel retains a valuation specialist to serve as either a consulting expert or testifying expert in the transfer-tax-related controversy matter.

This discussion summarizes what tax counsel needs to know to retain and work with the valuation specialist during a tax controversy engagement.

Counsel may look for a valuation specialist who has specialized experience and expertise in one or more of the following:

1. Valuing private companies in the subject industry segment
2. Conducting valuations of the subject valuation interest (e.g., S corporation stock, family limited partnership ("FLP") ownership interests, restricted public stock, contract rights, etc.)
3. Conducting analyses for the specific purpose that is relevant to the subject dispute (e.g., gift tax, estate tax, charitable contribution deduction, etc.)
4. Providing an expert report and providing testifying expert services at deposition and/or at trial, if relevant

This discussion provides practical guidance to tax counsel involved in such taxation, audit, appeal, or litigation matters with respect to selecting and working with a valuation specialist. This discussion summarizes the typical development procedures and the typical reporting procedures related to the valuation of a private company, business ownership interest, security, or intangible asset. And, this discussion summarizes the professional standards and practices that specialists typically follow as part of the valuation process.

Selecting the Valuation Specialist

Tax counsel should exercise due diligence in selecting the specialist. Some of the selection criteria may include the following:

1. The qualifications (experience and expertise) of the valuation firm
2. The qualifications (experience and expertise) of the individual specialist
3. Any prior relationships of the valuation specialist with the subject company

Considerations regarding the Valuation Firm

There are many types of professional firms that provide valuation services, including public accounting firms, industry specialist consulting firms, valuation groups within general financial advisory services firms, business valuation firms, forensic analysis firms, economic consulting firms, and many others.

Some of these firms are very small, including sole practitioners and small professional practices. Some of these firms are quite large, with dozens of offices and hundreds of practitioners.

Some firms specialize in the analysis of certain types of business ownership interests, such as private companies, private business ownership interests and securities, professional practices or licenses, or intangible assets and intellectual property. Some firms specialize in the analysis of certain industries or industry segments.

Some firms specialize in controversy-related forensic analyses. These firms primarily specialize in providing forensic-related consulting expert services and testifying expert services. In contrast, some firms provide valuation services for a broad variety of purposes, including transactions, financings, taxation, financial accounting, corporate planning—as well as tax-controversy-related purposes.

The qualifications of each valuation firm can be demonstrated in different ways. Some tax counsel may prefer firms that specialize in performing valuations for a specific purpose (e.g., transfer tax disputes, income tax disputes, property tax disputes). Other counsel may prefer firms that are more generalist in nature—that is, firms that do not focus exclusively on engagements for one particular purpose.

Nonetheless, the selected firm should be able to demonstrate its professional experience related to:

1. conducting valuation analyses for the subject taxation-related purpose and
2. conducting valuation analyses that can withstand a contrarian review (e.g., tax audit, appeals officer review, litigation cross examination).

Tax counsel may be particularly interested in the firm's valuation experience:

1. in the subject company's industry segment and
2. in the subject taxpayer's valuation issue (e.g., C corporation stock, S corporation stock, nonvoting stock, preferred stock, restricted public stock, limited liability company units, FLP interests, contract rights, intellectual property, etc.).

Important Issues in the Valuation

There are relatively few areas that distinguish company valuations prepared for one purpose from company valuations prepared for another purpose. However, the valuation firm—and the selected valuation specialist—should be familiar with such differences. For example, the following issues may be important in the business, security, or intangible asset valuation:

1. The appropriate standard of value and the appropriate premise of value based on the purpose of the analysis; that is, the valuation standard and the valuation premise typically will be different for analyses performed for transaction, taxation, accounting, litigation, or other purposes
2. The identification and valuation of any personal goodwill component related to the private company owners
3. The measurement of any value appreciation (or depreciation) between two dates (e.g., the date of formation of an FLP and the date of the transfer of the FLP partnership interests)
4. The amount of any extraordinary (i.e., above the industry average) business, security, or intangible asset value appreciation during a specific time period
5. The valuation of the private company on multiple dates (e.g., before the breach of a noncompete agreement, after the breach of a noncompete agreement, the breach of contract trial date, etc.)
6. The use of forensic accounting procedures—to identify unreported assets, unrecorded

liabilities, company-paid personal expenditures, and the like

7. The identification and quantification of valuation adjustments (i.e., discounts and premiums) related to lack of marketability, lack of control, lack of voting rights, key person dependence, and so forth
8. The identification and quantification of any buyer-specific synergistic or strategic value increments that may be a component of the business transaction price for a transaction that occurred before or after the taxation-related valuation date

Considerations regarding the Valuation Specialist

The professional qualifications of the individual valuation specialist are also important. The valuation specialist will provide consulting expert services to counsel. And, the valuation specialist may also provide testifying expert services. In addition, the specialist may also provide settlement negotiation, audit support, and other litigation support services. Therefore, the professional qualifications of the individual specialist should be able to:

1. impress a tax auditor, appeals division officer, or judicial finder of fact and
2. withstand a rigorous contrarian scrutiny (from, say, the Internal Revenue Service or Department of Justice legal counsel).

While assessing the professional qualifications of the valuation specialist, tax counsel may inquire about that specialist's personal experience in conducting valuations:

1. related to the subject type of company ownership interest;
2. in the subject company's industry segment; and
3. within a negotiation, audit, or other contrarian environment.

In terms of education, many valuation specialists have formal education in finance, accounting, and/or economics. In the same respect, many (but not all) valuation specialists hold one or more professional valuation credentials.

There is no statutory, judicial, or regulatory requirement that a specialist hold any particular valuation-related professional credential. Many industry consultants, economists, college professors, forensic accountants, and other types of professionals provide valuation services—without having earned a valuation-related professional credential.

Nonetheless, counsel should be aware of the valuation professional organizations ("VPOs") that offer valuation-related training, examination, credentialing, and continuing education programs. Some of the professional credentials—and the related VPOs—in the business valuation discipline include the following:

1. The accredited in business valuation ("ABV") credential is granted by the American Institute of Certified Public Accountants ("AICPA")
2. The accredited senior appraiser business valuation credential is granted by the American Society of Appraisers ("ASA")
3. The certified business appraiser ("CBA") credential was previously granted by the Institute of Business Appraisers ("IBA") (see explanation below)

4. The certified valuation analyst ("CVA") credential is granted by the National Association of Certified Valuators and Analysts ("NACVA")

In 2008, the IBA merged into NACVA. While NACVA no longer grants the CBA credential to new candidates, it does support and maintain the CBA program for the current CBA credential holders.

Each of these VPOs has developed its own set of requirements in order for a candidate to earn its professional credential. Generally, each of the VPO credentialing requirements include college education, a minimum amount of practical experience, attendance at technical courses and specialized training programs, reviews of demonstration reports, recommendations of current credentialed members, and the passing of a comprehensive technical examination.

Each of the VPOs also has ongoing ethical standards compliance requirements and continuing professional education requirements.

In addition to these VPO credentials, many valuation specialists are either certified public accountants ("CPAs") or chartered financial analysts ("CFAs").

The CPA credential involves a uniform national examination and state-specific accountancy licensing requirements. Many CPAs are (but are not required to be) members of the AICPA. The CFA credential is granted by the Chartered Financial Analyst Institute ("CFAI").

Each of the VPOs (i.e., AICPA, ASA, IBA, and NACVA) has promulgated its own set of professional standards. (In 2008, the IBA professional standards were conformed to—and then merged into—the NACVA professional standards.) The most voluminous of these various sets of business valuation professional standards is the AICPA Statement on Standards for Valuation Services ("SSVS"). The title of SSVS is Valuation of Businesses, Business Ownership Interests, Securities, and Intangible Assets.

Unrelated to any of the above-mentioned VPOs, the Appraisal Standards Board of the Appraisal Foundation promulgates the Uniform Standar*ds of Professional Appraisal Practice* ("USPAP"). The USPAP standards 9 and 10 relate to the development and the reporting (respectively) of a business valuation or an intangible asset valuation.

Prior Relationship of the Valuation Specialist and the Subject Company

Tax counsel may also inquire about independence issues when retaining the valuation firm or the individual valuation specialist. There may be a concern if the valuation firm works regularly for the subject private company—or for the subject taxpayer. That association may present the appearance of a bias.

That is, valuations performed for taxation compliance or litigation purposes require the valuation specialist to be independent of the private company—or of the subject taxpayer. The appearance of independence could be questioned if the valuation specialist is frequently retained by the private company or its owner/operators.

Reviewing the Valuation Report

The first step in tax counsel's review of—and dependence on—the valuation specialist's valuation report is to become familiar with the business, security, or intangible asset valuation process. Counsel should understand the level of due diligence and analysis that will be conducted by the valuation specialist in order to reach the valuation conclusion.

For example, counsel may be interested in whether the valuation specialist plans to interview the private company management—or with other parties—during the course of the valuation. These interviews may be conducted to:

1. understand the nature and history of the private company business and
2. discuss the historical and prospective performance (financial and operational) of the private company business.

If all parties agree, tax counsel may arrange for these interviews to take place in person at the company facilities. This arrangement may provide the valuation specialist with the opportunity to tour the company facilities and to view the physical condition of the company tangible assets.

If the parties agree, the interview process may also allow the valuation specialist to gain a better understanding of the private company (1) services, (2) strategic plan, (3) competitors, and (4) competitive position in the market.

The private company, security, or intangible asset valuation analysis may be documented with a narrative valuation report. As stated above, each of the VPOs has issued professional standards with regard to the reporting of business, security, and intangible asset valuations. The following sections provide a summary of the typical contents of such valuation reports.

Description of the Subject Ownership Interest

The valuation report should adequately describe the business ownership interest subject to valuation. Typically, this description includes the following:

1. The number of shares (or other ownership units) subject to valuation
2. The name of the company
3. The form of entity ownership

For example, a description of the valuation subject may read as follows:

> We estimated the fair market value of 20,000 shares of the nonvoting common stock of the Alpha Company ("Alpha"). Alpha is a corporation organized in the State of Delaware that has elected S corporation federal income tax status.

The above description informs the report reader as to (1) the number of securities (or other ownership interests) subject to valuation and (2) the name of the private company or business interest that is the subject of the analysis.

Standard of Value and Premise of Value

The valuation report should describe the standard of value (or definition of value) that is concluded in the analysis. Most valuation purposes have specific standards of value and premises of value that are appropriate for that particular purpose.

Tax counsel should inform the valuation specialist—as an instruction to the valuation specialist's assignment—of the appropriate standard of value in the subject matter. These purpose-specific standards (or definitions) of value are usually based on regulation, statute, or judicial precedent. Often (but not always), these purpose-specific standards (or definitions) of value are generally consistent with the fair market value standard of value.

There are several definitions of fair market value, but most of these definitions contain similar language. Fair market value is generally defined to be the price at which the property would change hands between a willing buyer and a willing seller, when neither is under any compulsion to buy or to sell, and with both parties having reasonable knowledge of the relevant facts.

Some valuation specialists expand this definition to add that the buyers and sellers are hypothetical buyers and sellers—as opposed to a specific buyer and/or seller. Nevertheless, the important elements of the definition remain the same. That is, an unrelated buyer and seller are coming together to conduct a transaction when neither is being forced to buy or sell and both parties are aware of all relevant information pertaining to the business ownership interest.

When the valuation is developed for tax planning, compliance, or controversy purposes, the valuation specialist will apply the fair market value definition promulgated in the corresponding regulations.

The valuation report should also describe the premise of value—that is, the report should explain whether the business ownership interest was valued:

1. as a going-concern business enterprise or
2. as an assumed orderly disposition of individual assets.

If the valuation specialist did not value the private company as a going concern, the valuation report should discuss the rationale for conducting the valuation in that manner.

Purpose of the Analysis

The valuation report should describe the purpose of the analysis. Typically, the purpose of the report is to provide information to the finder of fact in the subject tax controversy. The valuation report should describe the purpose of the analysis so there is no confusion over the intended use of the report.

> **"Under the fair market value standard of value, the valuation report typically does not consider any information that became available, or known, subsequent to the valuation date."**

Valuation Date and Report Date

The valuation report should indicate (1) the valuation date and (2) the report date. The valuation date is the date "as of" which the valuation specialist's opinion of value applies. The report date is the date the valuation report was prepared.

For example, the valuation report may estimate the fair market value of the company ownership interest as of December 31, 2018. However, the valuation report may not be prepared until April 15, 2019. In this case, the valuation date is December 31, 2018, and the report date is April 15, 2019.

In this example, tax counsel should understand that the valuation opinion takes into account all known and knowable information available through December 31, 2018. Under the fair market value standard of value, the valuation report typically does not consider any information that became available, or known, subsequent to the valuation date.

Level of Value and Prerogatives of Ownership Control

During the analysis, the valuation specialist will develop an understanding of the ownership control attributes (or the lack thereof) associated with the business ownership interest. For example, the business ownership interest may consist of one of the following:

1. A 35 percent noncontrolling ownership interest in the company total equity
2. A 51 percent ownership interest that has some ownership control level attributes
3. An 80 percent ownership interest that has many of the features of absolute ownership control

The valuation report should identify the business ownership interest and describe the prerogatives of ownership control that accompany the ownership interest.

For example, a 35 percent ownership interest may allow the holder to elect one company board member but may not provide any other opportunities to effectuate change at the company. In this case, the ownership interest would normally be valued as a noncontrolling ownership interest.

In contrast, a 51 percent ownership interest may allow the holder to exercise ownership control over several aspects of the company. These prerogatives of control may include, but are not limited to the following:

1. The appointing of new board members and management personnel
2. The changing or renegotiation of management compensation and perquisites
3. The issuing or repurchasing of the company shares
4. The issuing or repaying of the company debt
5. The changing of the strategic direction of the company

In this case, the valuation report should:

1. identify the specific control attributes of the business ownership interest and
2. explain how these attributes were considered in the valuation process.

A holder of an 80 percent ownership interest may not only have the prerogatives of control listed in the previous paragraph. That ownership interest holder may also have the ability to sell the private company or substantially all of the company assets. Once again, this level of ownership control should be identified in the valuation report and properly reflected in the valuation analysis.

In addressing the level of ownership control in the valuation report, the specialist may also discuss the distribution of the stock or the unit ownership. This issue may be particularly relevant in situations where no one shareholder has a controlling ownership interest in the company stock or partnership units.

Sources of Information

The report typically includes a section that lists the data and documents that the valuation specialist relied on to develop the valuation opinion.

By reviewing this section of the valuation report, counsel should develop an understanding of (1) the publicly available documents and (2) the non-publicly-available documents that the specialist considered in the valuation process.

The sources of information list should include not only the financial-related documents used in the valuation analysis (e.g., financial statements,

empirical market data), but the non-financial-related documents as well (e.g., client or supplier contracts, leases, licenses, corporation documents). The sources of information list should enable the report reader to identify the documents necessary to replicate the valuation analysis.

Description of the Company

The report should provide an adequate description for the reader to understand the fundamental position of the company. A description of the private company or business interest typically includes the following:

- A discussion of the history of the company and its current position
- A description of the goods or services provided by the company
- A description of the markets served by the company
- A description of the competitive environment in which the company operates and how the company is positioned within that competitive environment (i.e., the company's market position)
- A discussion of the principal facilities or other assets owned or operated by the company
- A discussion of significant relationships with related parties, clients, suppliers, and so on
- A discussion of any pending litigation or regulatory issues that are significant to the company
- A review of recent transactions in the private company stock/partnership units (if any)
- A discussion of any recent offers received for the company or for its assets

Overview of General Economic Conditions and Industry Conditions

The report should provide an overview of the general economic conditions and industry-specific factors that affect the valuation of the business interest.

The economic overview may include a discussion of trends in economic growth, inflation, consumer spending, consumer confidence, interest rates, construction starts, and business spending. In each case, the analysis should be tailored to the economic factors that most directly affect the company. This report section may also include a discussion of economic indicators that give insight into the future performance of the private company.

The industry overview section typically describes (1) how the industry operates and (2) recent trends affecting companies within the industry segment. The section may also describe (1) the company's position in the industry segment and (2) its market share relative to other competing companies.

Company Financial Performance

As part of the valuation process, the valuation specialist assesses the financial performance and financial condition of the private company. A summary of this financial analysis should appear in the valuation report.

The company historical financial performance is reflected on the company income statements and cash flow statements. The report may include a discussion of the following:

- The historical growth or decline in revenue
- The historical growth or decline in aggregate profitability (i.e., gross profit, operating profit, pretax profit, and net profit)
- The historical growth or decline in profit margins
- The historical growth or decline in cash flow
- The historical payments of dividends

The valuation specialist also reviews the balance sheet to assess the company's financial condition. The report may contain a discussion of the following balance-sheet-related items:

- The liquidity and working capital position
- The asset utilization by means of various financial ratios (e.g., accounts receivable turnover, inventory turnover, etc.)
- The tangible property base
- The capital structure and leverage

The financial analyst will include a discussion of significant financial statement trends and also a discussion of what factors caused the respective trends.

The valuation report may also include a discussion of how the company performs relative to other companies in the industry segment. This comparative financial analysis typically identifies the financial strengths and weaknesses of the company compared to other guideline/competing companies.

The comparative financial analysis should help the reader to understand how the company performs relative to other companies in the industry segment. This comparative performance analysis may be based on such factors as size, growth, profitability, and volatility.

Financial Statement Normalization Adjustments

When appropriate, the valuation specialist may make normalization adjustments to:

1. the private company financial statements and
2. selected guideline publicly traded company financial statements.

Financial statement normalization adjustments may be necessary in order to present the company's financial performance on the same basis as the selected guideline companies' financial performance.

The following list includes some of the financial statements adjustments that the specialist may consider:

- Adjustments for extraordinary or nonrecurring income and expense items
- Adjustments for differences in inventory (and other) accounting methods (e.g., LIFO method, FIFO method)
- Adjustments for nonoperating income and expense items
- Adjustments for non-arm's-length transactions/arrangements
- Adjustments for excess compensation or other benefit expense

The valuation report should identify any financial statement adjustments and explain the rationale for each adjustment.

Generally Accepted Business Valuation Approaches and Methods

There are three generally accepted business valuation approaches: the market approach, the income approach, and the asset-based approach. (An explanation of the generally accepted intangible asset valuation approaches is beyond the scope of this discussion.)

The valuation report should describe which valuation approaches—and which valuation methods within each approach—the specialist applied in the analysis. In the same respect, the report should explain which valuation approaches (or methods) were not applied in the analysis—and why the specialist did not apply them.

With regard to the market approach, and specifically the guideline publicly traded company method and the guideline merged and acquired company (also sometimes called the guideline transactions) method, the valuation report should include the following:

- **The criteria the specialist applied to select the guideline companies.** The selection criteria may include Standard Industrial Classification code, business description, size, growth, profitability or a combination of several relevant factors.
- **A description of each selected guideline company.** This description may include a discussion of each selected guideline company's business, its products and/or services, and its position in the market. Other information, such as whether the guideline company recently completed acquisitions, may also be relevant.
- **The market-derived pricing multiples the valuation specialist selected for the analysis.** These pricing multiples may include invested capital pricing multiples or equity pricing multiples. Industry-specific factors often influence the type of market pricing multiples that the specialist applies in the valuation analysis.

  For example, the valuation of an engineering and architectural firm may involve the application of market-derived pricing multiples that are based on (1) the market value of equity of the firm and (2) the earnings and/or the book value of the firm's total equity capital.

  In contrast, the valuation of a manufacturing company may involve the application of market-derived pricing multiples that are based on (1) the market value of invested capital of the company and (2) the invested capital earnings and/or the invested capital cash flow of the company.
- **The rationale for selecting the market-derived invested capital pricing multiples that are applied to the company financial fundamentals.** The report reader should be able to understand the valuation specialist's thought process for arriving at the selected valuation pricing multiples. The application of an average or median market-derived pricing multiple, with no support for such a selection, is typically not appropriate.
- **The rationale for the selected weighting used in the valuation synthesis.** For example, if the value indication based on projected cash flow is assigned more (or less) weight than the value indication based on trailing 12-month cash flow, then the report should explain why.

With regard to the income approach, and specifically the discounted cash flow method, the valuation report should include the following:

- **A discussion of who prepared the financial projections**. The financial projections are often prepared by the company management. In other cases, the financial projections may be prepared by the specialist with input from the company management.

  In the case of management-prepared financial projections, the report may explain how the specialist tested the reasonableness of the financial projections. In all cases, the financial projections should be supportable.

- **The appropriate matching of financial projections and the present value discount rate**. For example, if the discounted cash flow method incorporates a projection of invested capital cash flow, or the amount of cash flow available to invested capital, then the present value discount rate should be the weighted average cost of capital.

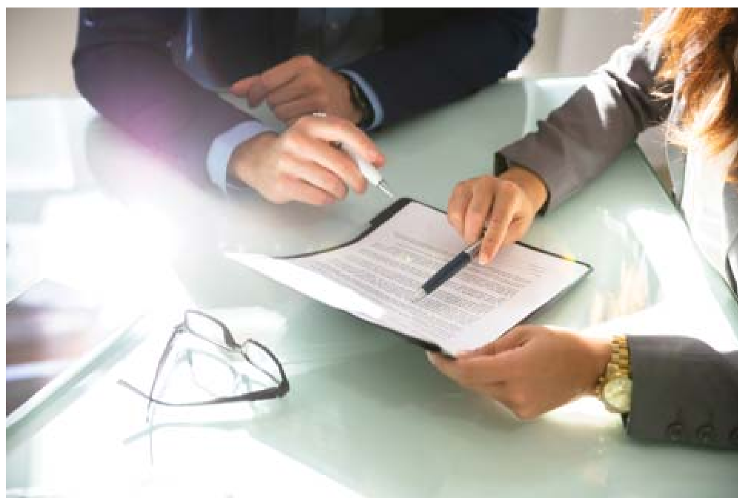
  In contrast, if the analysis incorporates a projection of cash flow available to equity capital, then the present value discount rate should be the cost of equity capital.

- **A discussion of the cost of capital components**. This discussion may include an explanation of how the specialist estimated the cost of equity capital, the cost of debt capital, and the weighting of each capital component in a weighted average cost of capital calculation.

- **Support for the selected residual value pricing multiple or residual value direct capitalization rate**. In many business, security, or intangible asset valuations, the residual value (also called the terminal value) may represent a significant portion of the total value.

  As a result, the selected residual value pricing multiple, or residual value direct capitalization rate, often has a substantial effect on the value conclusion. The specialist's rationale for the selected residual value pricing multiple, or the selected long-term growth rate within the residual value direct capitalization rate, should be adequately explained and supported.

The generally accepted asset-based approach valuation methods include the asset accumulation method and the adjusted net asset value method. While the income approach and the market approach valuation methods focus on the company's income statement, the asset-based approach methods focus on the company's balance sheet.



The application of the asset-based approach involves a valuation of both (1) all of the company's assets—both tangible and intangible—and (2) all of the company's liabilities—both recorded and contingent.

The asset accumulation method involves the discrete revaluation of all of the company's assets and liabilities. The adjusted net asset value method involves the collective—or aggregate—revaluation of all of the company's accounts. This revaluation procedure often involves the application of the capitalized excess earnings method ("CEEM").

Typically, in the application of the asset-based approach, at least one intangible asset category is revalued by the application of either (1) the multiperiod excess earnings method ("MEEM") or (2) the CEEM.

Tax counsel should be aware that the asset-based approach may be used to estimate the going-concern value of an operating company. That is, the asset-based approach (unless specifically applied to conclude such a value) does not conclude the liquidation value of the going-concern company. Finally, before the application of valuation adjustments, the asset-based approach typically concludes a marketable, controlling ownership interest level of value.

Valuation Synthesis and Conclusion

The valuation report should contain a section that provides (1) a valuation synthesis of the alternative value indications and (2) a final value conclusion for the company or ownership interest.

The following factors should be included in this report section:

- **A discussion of how each value indication from each valuation approach and method was weighted in the final value conclusion.** An explanation should be provided for each of the selected weightings.

- **A discussion of any valuation adjustments—that is, valuation premiums or discounts—that may be appropriate to reflect the ownership control, or lack of ownership control, attributes of the company or business ownership interest.** The discussion of the application of valuation adjustments should include:
  1. the rationale for each valuation premium or valuation discount and
  2. the supporting data or factors considered by the valuation specialist to select the valuation premium or valuation discount.

  The ownership control premium should reflect the adjustments that were made to the company financial statements. In other words, if the specialist adjusted the company financial performance for ownership control level/discretionary items, then the specialist should not reflect these same control price benefits a second time through the application of an ownership control premium.
- **A discussion of nonoperating assets (or liabilities) that need to be factored into the analysis.** These may include excess cash or securities, related party loans, excess land, investments in other companies, or other assets that have not been properly reflected in the valuation analysis.
- **A discussion of the illiquidity, or lack of marketability, of the business interest.** Most noncontrolling ownership interests are relatively illiquid.
- **A discussion of any contingent and limiting conditions.** The report should contain language that lists any contingent and limiting conditions regarding the analysis and opinion.

After reviewing the valuation report, tax counsel—or any other report reader—should be able to understand the following issues:

- Was the report readable and easy to understand? Or, was it filled with undefined valuation terms and jargon?
- Was the report comprehensive and organized in a logical manner?
- If more than one valuation date was considered, has the concluded value changed over time, and if so, what were the primary drivers of this change in value (i.e., the company performance, the subject industry or market performance, or a combination of the two)?
- Has the company's financial performance improved or deteriorated over time, and has the concluded value changed accordingly?
- Which generally accepted valuation approaches and methods were applied in the analysis? And, why were they applied?
- Does the value conclusion seem reasonable given (1) the historical and projected financial performance of the company, (2) the relevant market-based data, and (3) the relevant general economic conditions and industry-specific conditions?
- Does the value conclusion properly reflect the relevant standard of value, premise of value, and other purpose-specific factors and/or legal instructions?

Summary and Conclusion

Tax counsel may need to retain a valuation specialist to develop the value of a private company, a business ownership interest, a security, or a contract right or other intangible asset. These valuations are sometimes needed with regard to tax planning, tax compliance, and tax controversy matters. And, these matters may relate to gift tax, estate tax, generation-skipping transfer tax, or other wealth transfer tax matters.

This discussion assumed that the tax counsel retains the valuation specialist to assist counsel in the representation of a taxpayer client in a tax controversy matter.

This discussion summarized some of the issues that tax counsel may consider in the selection of a valuation specialist. This specialist may assist the tax counsel as a consulting expert or as a testifying expert. In addition, this discussion summarized the development procedures and the reporting process related to the private company, closely held security, or intangible asset valuation.

Tax counsel should be generally aware of the professional standards and practices related to the development and reporting of the valuation. This is because, in addition to retaining the valuation specialist, tax counsel may have to work with, review the work of, rely on, and defend the selected specialist.

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What Tax Counsel Needs to Know about the Valuation Due Diligence Process

Robert F. Reilly, CPA

Gift tax, estate tax, and generation-skipping transfer tax controversies often involve the transfer of a private company, business ownership interest, security, or intangible asset. These controversies often involve the valuation of these private business ownership interests. In these instances, tax counsel often retain a valuation analyst ("analyst") to serve as either a consulting expert or a testifying expert. As part of the valuation process, the analyst typically performs due diligence related to the private company and the taxpayer company owner/operator. This discussion summarizes what the tax counsel (and the taxpayer owner/operator) needs to know about this tax-controversy-related valuation due diligence process.

Introduction

This discussion assumes that tax counsel represents a private company owner/operator (or other high-net-worth individual) in a valuation-related gift tax, estate tax, or generation-skipping transfer tax controversy. This discussion assumes that the valuation issues in the controversy relate to the transfer of a private company or professional practice, a private business ownership interest, a closely held security, or an intangible asset.

This discussion assumes that the tax counsel retains a valuation analyst ("analyst") to assist with the tax-related valuation controversy. This discussion considers the procedures that such an analyst may perform during the due diligence stage of that valuation analysis. In such tax controversy matters, the tax counsel often retains, works with, reviews the work of, relies on, and defends the analyst. Therefore, counsel should have at least a foundational familiarity with the analyst's due diligence procedures.

This discussion assumes that the analyst will serve as either a consulting expert or as a testifying expert in the tax controversy matter.

In such controversy-related valuation assignments, the analyst often conducts due diligence interviews (sometimes called management interviews) as part of the valuation assignment. For purposes of this discussion, the due diligence interview process involves inquiries (usually in person, sometimes in writing) to any level of employee of the subject private company. For purposes of this discussion, the term "management" encompasses all levels of the organization from, say, staff accountants up to the owner/operator (for a private company)—and up to the board of directors (for a public company).

In addition, the analyst sometimes performs due diligence interviews of parties who are not employees of the subject private company. These parties may include former employees, independent auditors, legal counsel, commercial bankers, contractors, customers, and suppliers.

In the tax controversy engagement, the analyst may be asked to reach a valuation opinion with regard to the private company, ownership interest, security, or intangible asset. Often, the analyst learns more about the private company, ownership interest, or security from the due diligence interviews than from any other single source. And, that other single source may include the documents provided by the private company owner/operator or by the taxpayer's counsel.

Information obtained by the analyst during the interview process often affects the development of, the conclusion of, and the reporting of, the controversy-related valuation. The work product of the analyst's efforts is usually an expert report prepared for the litigation and/or expert testimony before a judicial finder of fact.

The due diligence interview process is a procedure performed in virtually every valuation analysis developed within a controversy context. This discussion provides guidance to tax counsel (and to the private company owner/operator) as to what to expect during the due diligence interview process. This discussion also provides a checklist for the analyst with regard to the topics to consider during the due diligence investigation.

In particular, this discussion considers the following topics:

1. Best practices with regard to the due diligence interview process
2. Typical questions that the analyst may ask during the due diligence interview process

The Due Diligence Interview Process

There are many ways for the analyst to conduct the due diligence interview. There is no absolutely "right" way—or no absolutely "wrong" way—for the analyst to conduct the due diligence interview. However, there are some procedural issues that may help the analyst to conduct—and to document—an effective due diligence interview.

First, the analyst should be thoroughly prepared to conduct the interview. The motto "be prepared" is good advice for every aspect of a controversy-related analysis. This "be prepared" advice is especially appropriate during the interview process.

The analyst's preparation typically includes the performance of the following procedures:

1. Thoroughly review the private company's website and any other publicly available data about the company
2. Completely review all of the documents that have been provided by the company owner/operator and/or the taxpayer's counsel
3. Comprehensively review and analyze the company's historical and prospective financial statements, paying particular attention to the year-to-year changes in the company's financial statement account balances
4. Thoroughly research the company's industry segment and the local, regional, or national economy (as applicable)
5. Prepare a specific list of written questions to ask to each person who will be interviewed during the due diligence process

Second, it is important for the analyst to interview the appropriate individuals. Determining who are the appropriate individuals to interview may be a collaborative process, with the participation of tax counsel. The selection of exactly who are the appropriate individuals to interview will vary with each valuation analysis.

Therefore, the analyst may discuss with tax counsel the general topics that will be covered during the due diligence interview process. The analyst should request to interview the individuals (at whatever level within the company organization) who are the most knowledgeable regarding the proposed interview topics.

In some tax-related valuation analyses, it may be useful for the analyst to interview individuals from outside of the private company. Such individuals may include the following:

1. Independent accountants
2. Commercial bankers
3. Principal customers
4. Principal suppliers
5. Principal competitors
6. Former management employees

The analyst should balance the need for client confidentiality with the need for information when determining which individuals to interview during the valuation.

Third, the analyst should understand the interviewee's bias, if any. In a typical valuation, the role of the analyst is to conclude the value of the company or ownership interest.

In many valuations, and especially when the owner/operator has worked for the private company for a long time, the management has much more information about the company than the analyst has. This access to (and familiarity with) information gives the owner/operator an advantage in presenting a particular point of view to the analyst.

However, the analyst should endeavor to uncover the complete truth about the issues related to the private company or ownership interest by:

1. being sufficiently prepared to conduct the due diligence interviews and
2. being sufficiently prepared to anticipate the potential bias of the company owner/operator or other interviewee.

Fourth, if the analyst can control the interview process, the due diligence interview should not be restricted to one interview session.

Let's assume that the analyst follows the due diligence guidance discussed above—that is, the analyst (1) is prepared, (2) interviews the appropriate individuals, and (3) filters out any potential interviewee bias. Nonetheless, the initial due diligence interview may uncover unexpected issues about the private company or ownership interest.

These issues may require the analyst to conduct additional research and, consequently, to conduct additional follow-up interviews with the company owner/operator.

These follow-up interviews are often needed to allow the analyst to pursue unexpected issues raised during an initial interview. These follow-up interviews may be necessary to help the analyst resolve conflicting "stories" from multiple interviewees. And, these follow-up interviews may be helpful to determine whether the same interviewee changes his or her "story" after a period of time.

New and unexpected issues that are uncovered in the initial interview often turn out to be the important issues in the valuation.

The analyst's understanding of what these few issues are—and how these issues affect value regarding the private company or ownership interest—and then presenting a persuasive argument for the appropriate treatment of these few issues can allow the tax counsel to reach a favorable outcome for the taxpayer client.

And, the due diligence interview process often helps the analyst to identify which issues are important to the value conclusion.

Caveats regarding the Due Diligence Questions

It is important for tax counsel (and the analyst) to recognize several caveats regarding the use of any standardized list of due diligence interview questions. First, the list of questions presented in Exhibit 1 is not intended to be comprehensive or all-inclusive. And second, not every question listed in Exhibit 1 is appropriate for every valuation.

The list provided in Exhibit 1 is generally applicable to a valuation involving a private company or closely held business ownership interest. The list provided in Exhibit 1 should not substitute for the application of the analyst's independent judgment and professional experience.

Summary and Conclusion

The interview process is one part of the analyst's due diligence procedures performed during the tax controversy valuation of a private company, business ownership interest, security, or intangible asset.

This discussion presented the foundational elements that tax counsel should be aware of regarding the due diligence component of the controversy-related valuation.

Related to any valuation, it is important for the analyst to effectively conduct the due diligence interview process. The due diligence interview process is an important procedure. During the due diligence interview process, the analyst often learns important information that may influence the quantitative analyses related to the valuation.

The primary purpose of the due diligence interview is to enable the analyst to get questions answered. In addition, the interview process may also be helpful to uncover information that the analyst may not otherwise have access to.

A list of representative due diligence interview questions is presented in Exhibit 1. This list is not intended to be comprehensive. This list is intended to provide general guidance to counsel who may work with the analyst in the interview process.

Tax counsel (and the analyst) should recognize that every private company, business ownership interest, security, or intangible asset has unique attributes. And, both the list provided below—and the information provided above—should not substitute for the analyst's application of independent judgment and professional experience.

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Exhibit 1
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

For purposes of this exhibit, the due diligence interview questions are categorized into four principal categories:

1. Questions related to the business operations of the private company or the business ownership interest
2. Questions related to the subject industry segment and the subject economy
3. Questions related to the financial statements of the private company or of the business ownership interest
4. Questions related to specific events that may impact the private company or the business ownership interest

Even the most experienced analyst may fail to ask the perfect question to uncover every material issue related to the valuation. Therefore, at the end of the due diligence interview session, the analyst may ask each interviewee a catch-all question. For example, the analyst may ask, "Do you know of any information that has not been covered and that could have a bearing on the issues we talked about?" This type of general question may provide an opportunity for management to volunteer any material information that was previously undisclosed during the interview.

Questions Related to the Company Business Operations

This category of questions helps the analyst to understand how the private company or the ownership interest operates. By asking these questions, the analyst may gain an understanding of the business risks and opportunities that exist for the private company or the business ownership interest.

Every tax-related valuation has unique aspects. These questions may help the analyst to uncover the factors that are unique to the particular valuation analysis.

Company History and Organization

1. When was the company founded?
2. Describe the key events in the company's history.
3. Describe any historical mergers, acquisitions, or divestitures.
4. Describe any historical ownership changes.
5. Describe any historical changes in the company's lines of business.
6. Describe any historical changes in the geographic area served by the company.
7. Provide a list of the company owners and their respective ownership interests.
8. Are any of the company owners currently active in the business? If yes, explain.
9. Is there any company stock that is subject to any stockholders' agreement, stock restriction agreement, buy-sell agreement, etc.?
10. List the names of any subsidiaries of the company or ownership interests in other companies, including the percentage owned by the parent company.
11. List all known related parties (including subsidiaries, affiliates, or relatives) that the company does business with.
12. List the states (or the countries) in which the company currently transacts business.
13. Describe the locations of the company facilities and the primary activities that occur at each facility.
14. Describe all historical transactions in the company stock in the five years prior to the valuation date. Describe the circumstances surrounding each of the transactions, including whether the transaction was at arm's length.
15. Describe all current litigation involving the private company or the business ownership interest classified by (a) claims against the company and (b) claims on behalf of the company.

Exhibit 1 (cont.)
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

Services (or Products) Offered

1. Describe the company's service (or product) lines and the approximate percentage of the most recent fiscal year company revenue and gross profit produced by each service (or product).
2. Describe the process by which the company prices its services.
3. What other services typically compete with the company?
4. What are the advantages and disadvantages of the company products/services versus the products/services of the competitor companies?
5. Why do clients select this company to provide services—instead of the competitor companies?
6. How long is the typical services sale cycle?
7. How frequently are the company's services changed/modified?
8. Which service lines have achieved the fastest revenue growth? Which services have reported the slowest revenue growth?
9. Which service lines are the most profitable? And, which service lines are the least profitable?
10. Does the company own patents, proprietary technology, or trade secrets that prevent or hinder competitor companies from duplicating its services?
11. Describe any services that are unique or not easily duplicated by new or existing competitors.
12. Is the revenue from the company services cyclical?
13. Is the revenue from the company services seasonal? If so, what are typically the strongest and weakest months for the company revenue?
14. What are the company plans for future services?
15. Describe the research and development activities of the company.

Manufacturing (or Production)

1. What percentage of the company's services (or products) is produced by the company? And what percentage of the company's services (or products) is subcontracted to a third party?
2. Where are the company's facilities?
3. Describe the company's production process for its services or products.
4. Is the company's process more labor intensive or more capital intensive?
5. What are the ages and the conditions of the company's facilities?
6. What is the capacity of each facility relative to the current operating levels?
7. Who is the manager of each facility and how long has he or she been employed by the company?
8. Does the company have any planned expansion of its facilities?
9. Does the company have any planned asset dispositions related to its facilities?
10. How do the facilities compare to similar companies in the same industry segment?
11. Do the facilities enable the company to earn superior or inferior profit margins compared to similar companies in the same industry segment? Why?
12. How technologically advanced are the company's processes?
13. Are the company's employees unionized?
14. Describe the company's relationship with its employees.
15. Does the company have any outstanding workers compensation claims?

Exhibit 1 (cont.)
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

Clients (or Customers)

1. Provide an overview of the company's client (or customer) base.
2. How are the company's services used by clients?
3. List the 10 largest clients (as measured by revenue) for the most recent fiscal years, and the percentage of total revenue from each of those clients.
4. For the company's largest recurring clients (as measured by revenue), how long has that party been a client of the company?
5. Does the company provide credit to any of its clients? If so, describe the conditions in which the company offers credit and the credit terms offered by the company.
6. Do clients tend to consistently purchase services from the same company, or do they periodically switch services providers?
7. Identify the most important markets for the company's services.
8. What are the key recent trends in each of these markets?
9. Are the company's key markets increasing, decreasing, or stable in terms of size?
10. Does the company have existing contracts with its clients? If so, provide copies of representative contracts.
11. Approximately how many current clients does the company have?
12. Is the company typically the sole supplier of services (or products) to its clients? Or do clients typically buy services (or products) from multiple suppliers?
13. Are there any large contracts, significant new clients, or new markets that the company anticipates adding during the next 12 months?
14. Are there any large contracts, existing clients, or present markets that the company expects to lose, terminate, or abandon during the next 12 months?
15. Does the company provide services to federal, state, or local governments and governmental agencies? If so, what percent of the company's total business is from federal, state, or local governments and governmental agencies?

Suppliers

1. What raw materials or other supplies does the company rely on?
2. Who are the company's principal suppliers?
3. How many suppliers does the company have?
4. Are any of those suppliers the sole source of supply for the company?
5. For each key supplier, how long has the company had a business relationship with that supplier?
6. Are any of the suppliers the only (or primary) entity that supplies the industry segment with a particular product?
7. Describe how supplies were/are priced.
8. What has been the trend in the cost of supplies?
9. List and provide copies of any long-term supply contracts or other special purchasing arrangements in place with suppliers.
10. How much notice is required by either the company or the supplier to terminate the business relationship?
11. Could the company switch suppliers without a detrimental impact on the business? Why or why not?
12. If the company had to find a new supplier for a key supply, (a) could it and (b) how long would it take to find a new supplier?
13. Has the company considered becoming more vertically integrated by acquiring a supplier or by expanding its line of business?

Exhibit 1 (cont.)
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

14. To what extent does the company fabricate versus assemble products, and how much flexibility does the company have in this respect?
15. Does the company use derivatives or other hedging activities to protect against increasing prices?

Sales and Marketing

1. What is the approximate total size of the market (in dollars) for the services (or products) offered by the company?
2. What is the company's estimated market share for each of the services offered?
3. How has the company's market share for each of its service lines changed in the last five years? Ten years?
4. What are the most important selling features of the company's services (i.e., price, quality, brand name, service, etc.)?
5. What warranty does the company offer for its services? And, how frequently do customers submit warranty claims?
6. How intense is the competition in the relevant industry segment?
7. How are the company's services priced?
8. Describe how new business opportunities are identified, followed-up, prioritized, and pursued, and by whom.
9. What distribution channels does the company use for its services?
10. How is technology used in the company's marketing?
11. Describe any changes in the company's marketing budget from year-to-year.
12. Describe the typical level of experience and typical tenure of the company sales staff.
13. Does the company depend on one employee or on a small number of employees to generate sales?
14. Describe the historical turnover rate of the company sales staff.
15. On what basis are the company's sales people compensated?

Management and Other Employees

1. Provide a copy of the most current company organization chart, along with resumes for the senior members of the management team.
2. How long have the senior members of the management team been employed by the company?
3. Do any of the senior members of the management team have known health issues? And, are any of the senior members of the management team close to retirement age?
4. Provide the total compensation for each member of the company management team, including perquisites.
5. How many hours per week do each of the senior members of the management team spend working for the company?
6. How many employees does the company have?
7. What unions (if any) represent the company's employees, and when do any union contracts expire?
8. How many employees are covered by collective bargaining agreements?
9. Has the company ever experienced any work stoppages due to a strike?
10. What is the total number of employees in each organizational area?
11. What are the critical skills and backgrounds needed in the development, production, and distribution of the company's products/services?
12. Identify any management or technical positions that have been difficult for the company to fill due to shortages of labor with the appropriate skills.

Exhibit 1 (cont.)
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

13. Describe the current labor market for the company's industry segment. That is, is the supply of employee candidates robust or sparse?
14. How extensively are independent contractors used?
15. List the members of the company's board of directors and provide a description of the background of each member.

Company Outlook

1. Describe the company's strengths, weaknesses, opportunities, and threats.
2. What are the most important things that the company must accomplish in order to be successful over the next five years?
3. What is the company's expected annual growth rate over the next five years in terms of revenue, operating profit, and net profit?
4. What is the biggest risk to the company achieving its projected financial results of operations?
5. What could cause the actual financial results of operations to greatly exceed the projected financial results of operations?
6. What is the level of capital spending required to support the company's projected revenue growth?
7. What are the known large and infrequent capital expenditures that will be made within the next five years (e.g., a plant expansion, an IT upgrade, the replacement of major equipment)?
8. Do you expect any changes in the service lines offered by the company in the next five years (due to either expansion or contraction)?
9. Are there any internal factors that may constrain the company's business growth, such as lack of access to capital or insufficient cash?
10. Does the company plan to acquire other companies in the next five years?
11. Are the company's profit margins expected to change over the next five years? Why or why not?
12. Does the company prepare an annual budget, plan, projection, or forecast? Describe the process that is applied to create the company's annual budget, plan, projection, or forecast.
13. Is the annual budget or forecast considered to be conservative, baseline, or aggressive?
14. How do the projected revenue growth and profit margins compare to historical revenue growth and profit margins?
15. Does the company plan any changes in ownership in the future (for example, through either share buybacks or the issuance of shares)?

Questions Related to Industry Segment and Economic Factors

These questions may help the analyst to put the private company in context relative to other similarly situated companies. In addition, these questions may also help the analyst to understand the long-term outlook for the company.

Industry and Economy

1. What national or regional economic factors impact the company's revenue (e.g., interest rates, inflation rate, disposable income, etc.)?
2. How does this company differ from other competitor companies in the relevant segment industry?
3. How has the company performed during recent recessions? During recent strong economic periods?
4. Is government regulation a factor for the company? If so, how?
5. What stage of the industry life cycle is the relevant industry segment in (i.e., introduction, growth, maturity, or decline)?

Exhibit 1 (cont.)
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

6. What are the most important recent developments or trends in the industry segment?
7. How many companies of your approximate size (e.g., revenue within plus or minus 50 percent) operate in the industry segment?
8. Is the industry segment generally comprised of small local companies or large multinational companies?
9. Describe the barriers to entry in the relevant industry segment.
10. How has the size of the industry segment changed in the last five years?
11. How is the size of the industry segment expected to change in the next five years?
12. What level of innovation and/or change is required to stay competitive in the industry segment?
13. Does the company generally lead or lag the industry segment in terms of new services, pricing, and other similar factors?
14. Is the technology employed at the company considered (a) outdated, (b) current, or (c) leading edge compared to the industry segment standard?
15. What trade associations does the company belong to?

Competition

1. Who are the most significant competitors of the company? Describe any publicly traded competitors—as well as any privately owned competitors.
2. Does the company management monitor the financial results and/or public filings of any publicly traded peer group companies? Describe which ones.
3. How large are the company's principal competitors in terms of revenue?
4. Where are the company's principal competitors located?
5. What is the estimated principal competitors' market shares for each of the services offered by the company?
6. What are the primary strengths and weaknesses of the principal competitors—versus the strengths and weaknesses of the subject company?
7. On what basis do companies in this industry segment compete (e.g., price, quality, service, technology, or some other basis)?
8. How often do the company's clients switch between the subject private company and its competitors?
9. How easy is it for the company's clients to switch between the subject private company and its competitors?
10. Do any principal competitors have proprietary technology, trade secrets, patents, copyrights, trademarks, or other intangible property that give them a competitive advantage over the subject company?
11. Do the company's principal competitors have greater or weaker economies of scale compared to the subject private company?
12. How has competition changed in the last five years (i.e., new competitors, regulatory changes that affected competition, erosion of pricing power, etc.)?
13. How does branding help (or hurt) the company to compete? Or, are the company's services unbranded and considered to be commodity products/services by the company's clients?
14. For each service line, if the company bids on a business opportunity, (a) what competitor companies does it typically compete against and (b) why is/isn't the company typically successful in winning the competitive bid?
15. How intense is the competition among the companies in the industry segment?

Questions Related to the Company Financial Statements

Understanding the private company's financial statements is an important procedure in just about any valuation. This is because of the significant impact that the financial statements may have on the company's business value.

Exhibit 1 (cont.)
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

A discussion of the private company's historical financial statements may also inform the analyst as to any financial statement normalization adjustments—or financial statement errors or irregularities—that need to be considered in the analysis.

The analyst should have a general understanding of each account on the company's financial statements. And, the analyst should have a more thorough understanding of the more material accounts on the company's financial statements.

Questions that relate to each and every account balance on the company's financial statements are not included in the list below. This is because the number of questions that relate to each individual account on the financial statements would be beyond the scope of this discussion.

Historical Financial Results

1. If applicable, provide a copy of the independent accountant's letters to the company management for the past five years.
2. Describe the accounting principles used by the company (e.g., revenue recognition methods, cash versus accrual basis, and property accounting methods).
3. Have there been any changes in the accounting principles applied in the preparation of the company financial statements over the past five years?
4. How do the current accounting principles compare to the accounting principles used by other competitor companies in the industry segment?
5. Explain all significant year-over-year changes in the financial statement accounts (e.g., the interviewee may explain changes such as (a) a 50 percent annual increase in accounts payable, (b) a 15 percent annual decrease in revenue, or (c) the gross margin improved from 30 percent of sales to 40 percent of sales).
6. Describe any nonrecurring or extraordinary income or expense items recorded during the past five years.
7. What plan does the company have for capital expenditures during the next 12 months?
8. Has the management or the board of directors received any offers to buy the company during the past five years? If so, describe the details of each offer or provide a copy of any written offers received.
9. Have any of the stockholders personally guaranteed the company loans? If yes, explain.
10. Describe any short-term and long-term sources of credit and how they were used over the past five years.
11. Is the company's current capital structure (a) sustainable and (b) expected to change over the next five years?
12. Has the company complied with all of its outstanding loan covenants? If not, explain why.
13. Discuss the company's dividend history and the outlook for future dividend payments.
14. Summarize any assets owned by the company that may be classified as (a) nonoperating assets or (b) excess assets. That is, are there any assets that do not contribute to the primary operations of the company (e.g., cash and cash equivalent balances that may not be needed for future working capital or capital expenditures)?
15. Describe all of the company's intangible assets and of the company's contingent liabilities that are not recorded on the company's balance sheet.

Questions Related to Specific Events That May Affect the Company

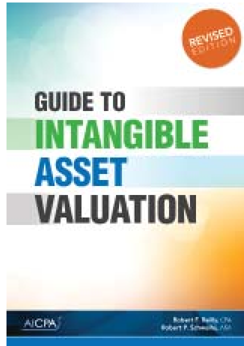
These questions are intended to help the analyst identify the most significant events that affected the private company or business ownership interest in recent years. These questions are also intended to help the analyst to identify the significant events that may affect the private company or business ownership interest in the near future.

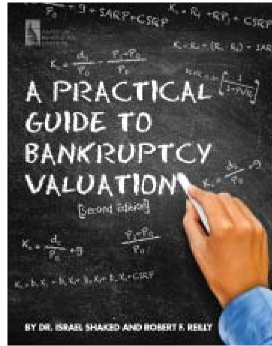
1. Does the company operate with any license, permit, franchise, or other agreement that permits the company to operate—either at the total entity level or at a particular location level? Which of these licenses, etc., are private party agreements? Which of these licenses, etc., are government-issued agreements?

Exhibit 1 (cont.)
Tax-Controversy-Related Valuation Analysis
Representation Due Diligence Questions

2. How important is location to the company's results of operations? Could the company move its facilities and still maintain its planned results of operations? What type of impact would a facility relocation have on the company's planned results of operations?
3. What type of intellectual property does the company own or use? Specifically, what patents, copyrights, trademarks, and trade secrets does the company own or use?
4. What procedures does the company employ to protect its intellectual property?
5. What would be the expected impact if the company lost the right to (or ability to) use its intellectual property?
6. Does the company either inbound license or outbound license any of its intellectual property? If so, please provide copies of all such licenses.
7. What are the most significant long-term contractual agreements that the company has entered into? For example, consider these types of long-term agreements: supplier agreements, customer/client agreements, executive employment agreements, noncompetition agreements, joint development agreements, joint venture agreements, etc. Please provide copies of each of those agreements. Have any such agreements even been unexpectedly terminated or violated? If so, please describe the impact of that unexpected agreement termination or violation.
8. How important are the company's banking relationships? How stable are the company's banking relationships? How frequently does the company change its banking relationships?
9. What are the company's principal sources of debt capital? What are the agreements (i.e., notes and debt indenture agreements, bond indenture agreements, long-term leases) that document those financing arrangements? Has the company ever violated the terms of any of these financing arrangements? If so, what were the consequences of such violations?
10. In the last five years, has the company participated in any mergers, service line or entity acquisitions, service line liquidations, or service line divestitures? Please describe each such transaction. Please describe the impact of each such transaction.
11. In the last five years, has the company implemented a restructuring of its long-term debt or a recapitalization or reorganization of its capital structure? Please describe each such transaction. Please describe the impact of each such transaction.
12. Does the company maintain confidentiality agreements, nondisclosure agreements, nonsolicitation agreements, or any similar agreements with any of its employees? If so, which employees—and how were these employees selected? Please provide copies of those agreements. Has the company ever had to enforce these agreements? If so, how?
13. In the last five years, has the company been involved in a taxation audit or dispute at any level? Has the company been involved in a regulatory agency audit or dispute at any level? Has the company been involved in an environmental audit or dispute at any level? If so, how was each of these audits or disputes resolved? What was the impact of each of these audits or disputes?
14. During the last 10 years, was the company involved in any litigation (as either plaintiff or defendant) involving competitors, merger or acquisition parties, contract counterparties, financial institutions, government agencies, or similar parties? If so, please describe the claims of each litigation matter. Please describe the resolution of each litigation matter.
15. During the last 10 years, was the company involved in any litigation (as either plaintiff or defendant) involving any member of company management, any company director, or any current or former shareholder? If so, please describe the claims of each litigation matter. Please describe the resolution of each litigation matter.

Valuation Textbooks Authored by Robert Reilly and Robert Schweihs





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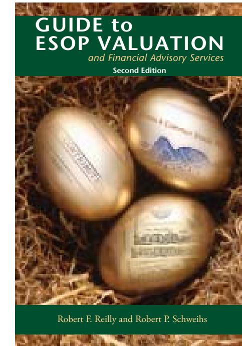

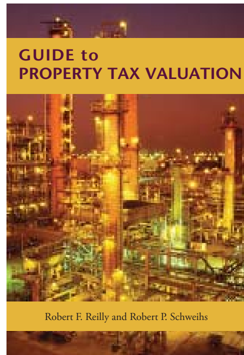

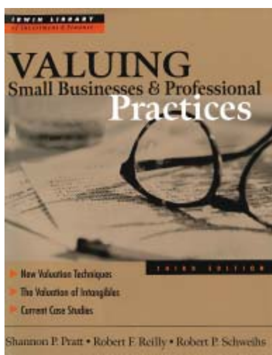

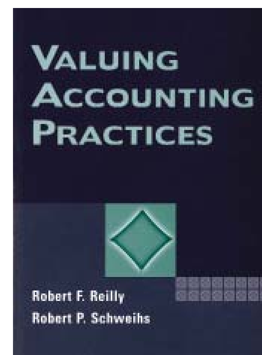

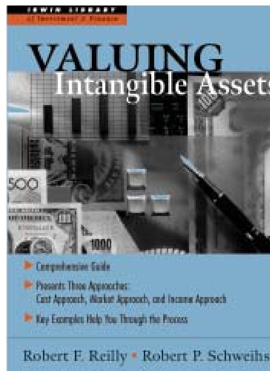

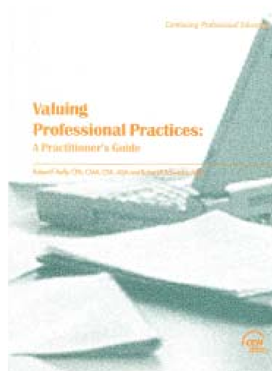

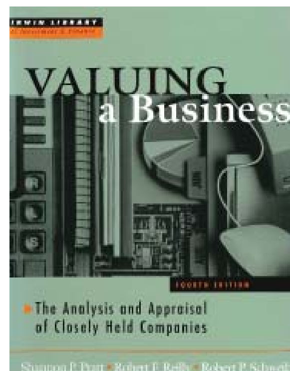

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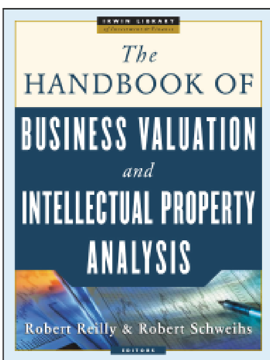

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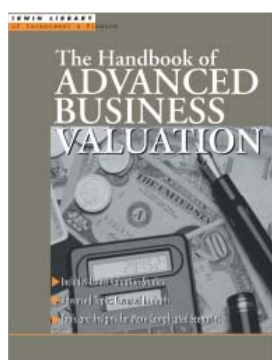

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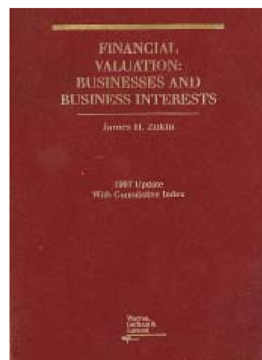
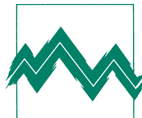


*   Authored by Robert Reilly and Israel Shaked, Ph.D.
** Authored with Shannon Pratt
*** Edited by Robert Reilly and Robert Schweihs



Willamette Management Associates

On Our Website

Recent Articles and Presentations

Bob Schweihs, a managing director of our firm, along with Liza Vance of The Walt Disney Company, delivered a presentation to the 43rd Annual Conference of the Institute for Professionals in Taxation. The conference was held June 23-26, 2019, in San Antonio, Texas. The title of Bob and Liza's presentation is "The Empire Becomes the Galactic Empire, Becomes the Rebel Alliance, Becomes the New Republic, Becomes the First Order, Becomes the Resistance—A Change of Ownership and Its Impact on Taxpayer Property Records."

Bob and Liza's presentation explores the steps to take to successfully transition, for personal property tax purposes, in a corporate acquisition. They identify common personal property issues such as obtaining, auditing, and correcting the target company's personal property list. They discuss transaction pricing and structuring issues, along with standards of value and premises of value in post-acquisition valuations.

Robert Reilly, a managing director of our firm, authored an article that was published in the April/May 2019 issue of *Financial Valuation and Litigation Expert*. The title of Robert's article is "Practical Guidance Related to Forensic Analysis Due Diligence Interviews."

Valuation analysts are often asked to perform valuation, damages, transfer price, and related economic analyses within a litigation environment. In such cases, analysts may be asked to assist with a forensic investigation. Robert's article discusses the procedures that analysts may perform during the due diligence stage of a forensic investigation. The article includes a checklist of topics to consider during the forensic due diligence investigation.

Robert Reilly also authored an article that was published in the Spring 2019 issue of the *American Journal of Family Law*. The title of Robert's article is "The Independent Investor Test for Reasonableness of Shareholder/Employee Compensation in Family Law Disputes: Parts I and II."

Controversies regarding the reasonableness of owner/employee compensation often arise in family law matters. In Part I, Robert looks at what reasonable compensation is. The article goes on to discuss relative court cases that have addressed reasonable compensation. In particular, Robert discusses the *H.W. Johnson v. Commissioner* case. He also discusses the five factors that should be considered when determining reasonableness. These factors were first discussed in *Elliotts v. Commissioner*. Robert's article explores the independent investor test method of determining reasonableness of compensation. In Part II, Robert explores the *Brinks Gilson & Lione v. Commissioner* case. This case involved application of the independent investor test. Although these cases are Tax Court cases, the issues explored in them are pertinent to family law cases as well.

Tim Meinhart, a managing director in our Chicago office, authored an article that was published in the February 2019 issue of *Trusts & Estates*. The title of Tim's article is "Valuation of Preferred Equity Interests in Estate Planning: A Review of Characteristics That Drive Value."

Preferred equity interests have been used for some time to accomplish certain estate-planning objectives. Tim's article examines the basic preferred equity interest characteristics that drive value. The article discusses procedures used to value preferred interests. It also explores guidance from the IRS related to the valuation of preferred interests. Finally, Tim examines the current interest rate environment for preferred equity interests.

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the Spring 2019 issue of the *American Journal of Family Law*. Robert's two-part article was titled "The Independent Investor Test for Reasonableness of Owner/Employee Compensation (part I of II) and (part II of II)."

Robert Reilly also authored an article that appeared in the April/May 2019 issue of *Financial Valuation and Litigation Expert*. The title of his article is "Practical Guidance Related to Forensic Analysis Due Diligence Interviews."

Robert Reilly also authored an article that appeared in the March/April 2019 issue of *Construction Accounting and Taxation*. The title of that article was "Due Diligence Procedures in Forensic Analyses."

Robert Reilly also authored an article that appeared in the April/May 2019 issue of *Financial Valuation and Litigation Expert*. The title of that article was "Practical Guidance Related to Forensic Analysis Due Diligence Interviews."

Justin Nielsen, Portland office vice president, had an article republished in the online publication *QuickRead* on May 2, 2019, located at www.quickreadbuzz.com. The title of that article was "Application of the Sales Projection Method in Measuring Trustee Breach of Fiduciary Duty Damages (Part I of II)." Part I of that article was originally published on May 15, 2018, and Part II of that article was originally published on May 23, 2018, with both parts located at www.quickreadbuzz.com.

In Person

Robert Reilly, firm managing director, and John Ramirez, Portland office vice president, will deliver a presentation at the NAPTR-TEC annual conference on October 22, 2019, in Phoenix. The topic of their presentation is "Fair Value and Fair Market Value—Conceptual Differences and Practical Differences."

Robert Reilly and John Ramirez will also be delivering a presentation at the Appraisal for Ad Valorem Taxation annual conference at Wichita State University on July 29, 2019. The topic of their presentation is "Standards of Value and Premises of Value—What Is Appropriate for the Unit Principle Valuation?"

Robert Reilly and Connor Thurman, Portland office associate, will also be delivering a presentation at the Appraisal for Ad Valorem Taxation annual conference on July 30, 2019. The topic of their presentation is "Finding Alpha—Measuring Size Risk Premium and Company-Specific Risk Premium in the Unit Principle Valuation."

Bob Schweihs, firm managing director, delivered a presentation on June 24, 2019, at the Institute for Professionals in Taxation ("IPT") annual conference in San Antonio, Texas. The topic of Bob's presentation was "A Change of Ownership and Its Impact on Taxpayer Property Records."

John Ramirez also delivered a presentation at the IPT annual conference on June 24, 2019. The topic of John's presentation was "No Space for Intangibles—Understanding How to Identify and Remove Intangibles."

Kevin Zanni, Chicago office managing director, will be delivering a presentation to the J.P. Morgan closely held asset management group in September 2019 in Columbus, Ohio. The topic of Kevin's presentation is "Significant Business Valuation Concepts."

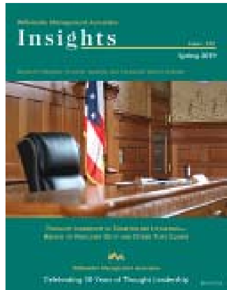
Jason Bolt, Portland office manager, delivered a presentation to the National Center for Employee Ownership ESOP Nuts and Bolts conference on July 11, 2019, in Bellevue, Washington. The topic of Jason's presentation was "ESOP Plan Designs That Work."

Encomium

Kyle Wishing, Atlanta office manager, was appointed as a member to the ESOP Association's Valuation Advisory Committee for fiscal year 2020.

John Kirkland, Atlanta office associate, has obtained the certified public accountant license in the State of Georgia.

Insights Thought Leadership Archives



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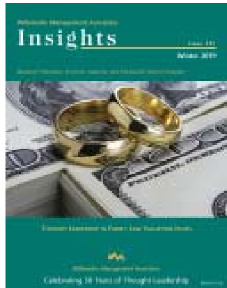

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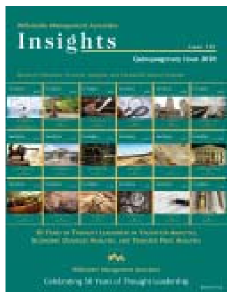

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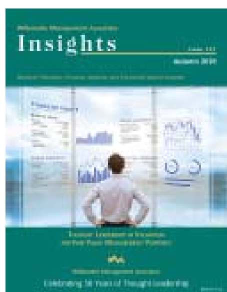

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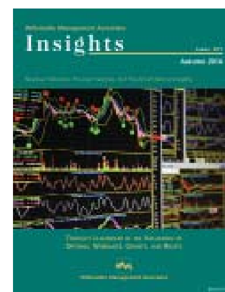

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Willamette Management Associates provides thought leadership in business valuation, forensic analysis, and financial opinion services. Our professional services include: business and intangible asset valuation, intellectual property valuation and royalty rate analysis, intercompany transfer price analysis, forensic analysis and expert testimony, transaction fairness opinions and solvency opinions, reasonableness of compensation analysis, lost profits and economic damages analysis, economic event analysis, M&A financial adviser and due diligence services, and ESOP financial adviser and adequate consideration opinions.

We provide thought leadership in valuation, forensic analysis, and financial opinion services for purposes of merger/acquisition transaction pricing and structuring, taxation planning and compliance, transaction financing, forensic analysis and expert testimony, bankruptcy and reorganization, management information and strategic planning, corporate governance and regulatory compliance, and ESOP transactions and ERISA compliance.

Our industrial and commercial clients range from substantial family-owned companies to Fortune 500 multinational corporations. We also serve financial institutions and financial intermediaries, governmental and regulatory agencies, fiduciaries and financial advisers, accountants and auditors, and the legal profession.

For 50 years, Willamette Management Associates analysts have applied their experience, creativity, and responsiveness to each client engagement. And, our analysts are continue to provide thought leadership—by delivering the highest level of professional service in every client engagement.

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