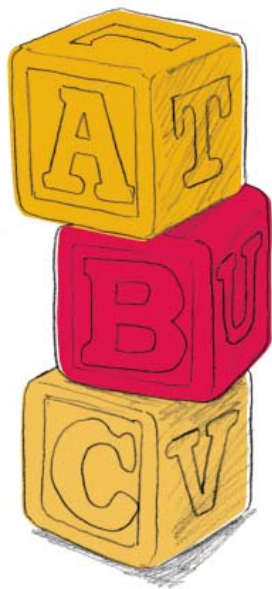


# Business Valuation Monitor

Value creation perspectives for corporate executives and the investment community March 2009

## Judgment calls in valuation: Discounts, taxes and subsequent events



Some of the liveliest debates in business valuation are currently taking place around three topics: 1) when to include subsequent events in a valuation report; 2) whether discounts for lack of marketability apply to a controlling ownership interest; and 3) how to calculate deductions for built-in capital gains taxes. While discounts are a perennial “hot” topic, the other two have risen from recent events in the legal and appraisal communities.

### Subsequent events

Earlier in 2008, the AICPA adopted its *Statement on Standards for Valuation Services* (SSVS 1). Among the many important provisions, the new standards clearly require valuation specialists to account for events that occur subsequent to the valuation date only when these events are “knowable or foreseeable.” Yet some analysts are uneasy about omitting a discussion of subsequent events from their valuation reports, particularly when a judge or jury—or even a client—will want to hear about them.

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## Judgment calls in valuation: Discounts, taxes and subsequent events (continued)

Many analysts resolve the problem of subsequent events by convincing the court (through their attorneys) to update the valuation report. Many times, the subsequent events won't materially impact the original conclusions, and analysts are thus able to account for them without substantially altering the bottom line.

But consider the subprime lending crisis, which began as early as the summer of 2007—although the extent of the damage wasn't felt in the banking and other industries for several months. When did the credit crisis (and its impact) become knowable and foreseeable? The answer may lie in evaluating what the economic experts and financial indicators were saying as of the valuation date. If this date falls in 2007, for example, when perhaps a few economic forecasters were predicting a downturn—but none as dire as the market declines that eventually took place—then the valuation would most likely omit the impact of these subsequent events.

That's not always what a client or attorney wants to hear. In these difficult cases, it becomes even more important for the valuation specialist to educate the court and the client on the timing of market events and financial inputs. In fact, many believe that it's the best "teacher" who will also make the best case for the trier-of-fact.

### Discounts for controlling interests?

Is there a valid, conceptual basis for applying a discount for lack of marketability (DLOM) to a controlling interest of a private (closely held) company?

Yes, but like all valuation issues, it depends on the facts and circumstances of the particular matter at hand. But the market for entire companies is less liquid than the public stock market, so many analysts believe that some transactional discount is appropriate, no matter what it's called. (Some use the term "controlling non-marketable interest.") Broker fees and legal fees may also enter into the final percentage, to be balanced, perhaps, by the receipt of dividends and other benefits of ownership. Ultimately, the discount will turn on the facts of the case, as well as the analyst's professional judgment.

### Built-in gains

In *Estate of Jelke v. Commissioner* (2007), the Eleventh Circuit Court of Appeals reversed an earlier Tax Court ruling that applied a present value approach to potential future capital gains taxes.<sup>1</sup> The current "bright line" rule, in both the Eleventh and Fifth Circuits, is to apply a dollar-for-dollar reduction for the entire unrealized capital gains tax, even if the business has no immediate plans to liquidate. A more recent case, *Estate of Litchfield v. Commissioner* (2009), the estate did not argue for a dollar-for-dollar reduction, but received similar results when the Court allowed consideration of expected post-valuation date appreciation.<sup>2</sup>

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Ultimately, the discount will turn on the facts of the case, as well as the analyst's professional judgment.



## Judgment calls in valuation: Discounts, taxes and subsequent events (continued)

At the same time, many valuation analysts still prefer to apply the present value of the anticipated future tax. It's more uncertain, but unless a sale of the business is imminent, there may be a stronger argument for measuring the estimated tax, recorded as a current liability. On the other hand, if there are several prospective buyers as of the valuation date, a better case can be made for deducting built-in gains taxes without calculating the present value of a hypothetical, future sale.

Clearly, *Jelke* and *Litchfield* recognized that the taxes on the sale of these business assets will eventually accrue; the only question is when and how much. Analysts and their attorneys should consider all relevant factors—and applicable law—when establishing the magnitude of imbedded capital gains. •



<sup>1</sup> Estate of Jelke III v. Commissioner, T.C. Memo. 2005-131, revd. 506 F. 3d 1317 (11th Cir. 2007).

<sup>2</sup> Estate of Marjorie deGreeff Litchfield v. Commissioner, T.C. Memo. 2009-21.

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