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Autumn 2022

Business Valuation, Forensic Analysis, and Financial Opinion Insights

Thought Leadership in Wealth Transfer Valuation Issues

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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.

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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.

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Thought Leadership in Wealth Transfer Valuation Issues

Editor for This Issue: Weston C. Kirk

Estate and Gift Tax Planning Thought Leadership

Estate and Gift Tax Valuation Thought Leadership

Income Taxation Thought Leadership

Bankruptcy Thought Leadership

Willamette Management Associates Insights

Forethoughts

This *Insights* issue celebrates over 50 years of Willamette Management Associates thought leadership related to wealth transfer valuation issues. The topics covered in this *Insights* issue provide high net worth families, tax counsel, estate planners, and wealth advisers with an understanding of the valuation topics that currently affect the trust and estates profession.

Independent valuations are often needed when families are transferring wealth to the next generation. These wealth transfers may include private corporation securities, publicly traded securities, family limited partnership interests, limited liability company interests, joint ventures, royalty income streams, and intellectual property assets. The valuation of these business interests can be an important part of an estate planning strategy.

In times of economic uncertainty, it may be appropriate to revisit the family's estate plan. Emily Dabney, Esq., with Hoffman & Associates in Atlanta, Georgia, describes three situations that should encourage the family business owner to reevaluate the family's succession plan.

This *Insights* issue presents valuation thought leadership discussions regarding the complexities of valuing promissory notes and preferred stock. This *Insights* issue also presents a thought leadership discussion regarding the environmental, social, and governance factors associated with the valuation of privately held companies.

Other thought leadership discussions explore (1) the analysis of the blockage valuation discount and (2) U.S. Tax Court considerations related to the reasonableness of executive compensation for shareholder/employees in private companies.

The valuation analysts in the Willamette Management Associates wealth transfer services practice assist high net worth families and their tax counsel with transfer (e.g., gift, estate, and generation-skipping), expatriation, and income (e.g., charitable gifting) tax planning and compliance. Our analysts serve as consulting experts and as testifying experts for tax controversies and intrafamily wealth disputes. Our analysts regularly provide taxpayers and tax counsel with valuation analyses developed for dispute resolution purposes.

We thank all of our clients, colleagues, and friends over the more than 50 years of our firm's history for their trust, loyalty, and support. We hope you enjoy this *Insights* issue.

About the Editor

Weston C. Kirk

Weston Kirk is a managing director with Willamette Management Associates, a Citizens company. He is also the director of our firm's Atlanta office.

Weston's practice includes business valuations, damages measurement analyses, and financial opinion services. Weston principally works in the firm's wealth transfer valuation services practice.

Weston serves 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 controversies and litigation; and various other intrafamily wealth transfer planning matters.

He prepares valuation and other economic analyses for transaction pricing and structuring, taxation planning and compliance, employee stock ownership plan transactions and financing, stock offerings, litigation expert testimony, and strategic information and planning purposes, among other purposes.

Weston holds a bachelor of business administration 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.

Weston holds the certified valuation analyst designation of the National Association of Certified Valuators and Analysts.

He is also a regular sponsor attendee of the Heckerling Institute and of the American College of Trust and Estate Counsel.

Best Practices Discussion

Economic Uncertainty: A Certain Time to Reevaluate an Estate Plan

Emily A. Dabney, Esq.

The United States is currently experiencing a multitude of events that beg the question: "Is a recession coming?" From record high inflation to rising interest rates, the strength of the U.S. economy appears to be uncertain. In times of economic uncertainty, estate planning may be the last thing on an individual's mind. However, a robust estate plan can afford an individual significant tax savings and can provide ease of mind for the individual and his or her family members. A succession plan is an important element to an estate plan, particularly for an individual who is a closely held business owner, who owns a substantial real estate portfolio, or who owns appreciated marketable securities. The current economic uncertainty—combined with the coming reversion (to pre-Tax Cuts and Jobs Act levels at the end of 2025) of the estate and gift tax exclusion amount and the generation skipping transfer tax exclusion amount—makes now the right time to reevaluate an estate plan. This discussion describes three typical succession plan scenarios, including consideration of the plan goals and the tactics for achieving those goals.

The Sunset on the Horizon

The Tax Cuts and Jobs Act of 2017 ("TCJA") has proven to be important in enabling high net worth individuals to transfer wealth out of their estates and to future generations. Upon its passage, the TCJA essentially doubled[1] the gift and estate tax exclusion amount, also known as the "applicable exclusion amount," and the generation-skipping transfer ("GST") tax exclusion from the 2017 amount of $5,490,000[2] to $11,400,000[3] in 2018.

Absent any intervention from Congress, the provisions that increased the applicable exclusion amount and the GST exclusion amount will expire (i.e., "sunset") on December 31, 2025. That sunset provision will cause the exclusion amounts to revert to 2017 levels (adjusted for inflation) beginning in the year 2026.

The increased applicable exclusion amount and the GST tax exclusion amount under the TCJA have made it possible for high-net-worth individuals to transfer more assets out of their estates. However, these exclusion amounts have also caused other individuals to overlook the benefits of having a more robust estate plan in place.

This situation is in part due to the fact that many people do not believe that their estates are valuable enough to warrant the cost of engaging attorneys and other advisers to create an estate plan. This belief is common because these individuals consider their estates to be valued below the current exclusion amounts of $12,060,000 (for married couples, the exclusion is combined, totaling $24,120,000[4]).

Even more modest estates that are below today's current exclusion amounts should consider utiliz-

"The challenge for advisers to engage individuals in estate financial planning is particularly important during times of financial crisis or economic downturn."

ing the current exclusion amounts as much as possible, as any remaining exclusion amount above the 2017 level that is left unused will be lost once the exclusion amount reverts.

In 2019, the Internal Revenue Service issued final regulations that provided that individuals who do transfer assets out of their estate in an amount greater than the pre TCJA exclusion amount, even if below the current exclusion amount, will have preserved those gifts made in contemplation of the exclusion amount as of the date of transfer despite the reversion of the exclusion amount to pre TCJA levels beginning in 2026. This means that if an individual transfers assets out of his or her estate that are valued at, for instance, $7,000,000, which is well below the current $12,060,000 exclusion amount but above the pre-TCJA exclusion amount, the Service will respect the gift, even if it is more than the exclusion amount in 2026, and the taxpayer will not be taxed on the transfer that, as a result of the increased exclusion amount, was not subject to gift tax when made. This consideration has prompted many estate planners to advise their clients to "use it or lose it."

Although an individual may not have a taxable estate based on today's exclusion amounts, the types of assets that the individual owns may still justify implementing a more robust estate plan.

Reassessing before a Recession

The challenge for advisers to engage individuals in estate financial planning is particularly important during times of financial crisis or economic downturn. With inflation in the United States increasing to its highest level in nearly 40 years, and the Federal Reserve's continued efforts to raise interest rates in an attempt to curb inflation, economists and business owners are concerned that a recession may be in the not too distant future for the United States.[6]

In addition to concerns surrounding inflation and increasing interest rates, individuals see the value of their assets, particularly stocks, begin to decrease. In June of 2022, the U.S. stock market officially entered a bear market, which occurs when the stock market decreases by roughly 20 percent.[7]

Declining asset values mean that individuals may need to use certain assets that they otherwise were hoping to refrain from using. As a result, the concept of transferring assets outside of one's estate, effectively making those assets unavailable for the owner's use, may not appeal to individuals who are weary of current and future economic conditions.

Certain asset values are decreasing and interest rates are on the rise. Despite this, interest rates are still at lower levels than we had seen during the Great Recession[8] and in the late twentieth century.[9]

However, high-net-worth individuals, as well as those with assets such as closely held businesses or real estate portfolios, may be well positioned to use such an economic circumstance to pass on more wealth to future generations.

Having an estate plan in place is important, no matter the circumstances. It becomes all the more important when considering factors such as ensuring ease of mind for your loved ones, the need for a succession plan, or minimizing tax liability so heirs may benefit in the long term from the assets an individual has accumulated over his or her lifetime.

The decrease in asset values that many individuals have been faced with this year, combined with the looming reversion of the applicable exclusion amount and the GST exclusion amount to pre-TCJA levels, makes now the best time to reevaluate an estate plan and any individual needs pertaining thereto.

Of particular importance is ensuring that the individual has an appropriate succession plan in place with his or her estate plan. Succession planning typically involves the continued management of a closely held business after its owner/operator has retired or passed away, and it is an important element in many estate plans.

Typically, closely held business owners strive to balance family goals and continued profits when thinking about a succession plan. An additional important element of estate planning is minimizing tax exposure and liability. This goal can be accomplished through various gifting and freezing techniques, without limiting an individual's options and flexibility.

That said, a succession plan that works for the closely held business owner may not necessarily work as synchronously as a plan for the highly appreciated marketable securities owner. However, with professional guidance, it is possible to meet both tax and succession planning goals, no matter the scenario or the nation's economic outlook.

Presented below are three scenarios for tax planning and succession planning, including the

typical goals and recommended planning solutions for individuals to achieve those goals.

Scenario 1: The Closely Held Business Owner

Many times, a married couple, or perhaps one individual in the relationship, may have an ownership interest in a closely held business, such as a family farm or factory. In these instances, it is not uncommon for the owner to want his or her family members to have an active role in the business from which they can benefit in the long term.

A lasting succession plan will help preserve the family business and its long-term value. Most importantly, maintaining the flexibility to modify succession planning is important in order to address certain business variables and economic factors that are in flux—as well as any family needs that may change over time.

To ensure that the owner's business does not increase the family estate or other death tax exposure as it increases in value, freezing or gifting techniques may be utilized. Through the implementation of such techniques, the owner transfers a portion of the business interest to an irrevocable trust.

When a business owner transfers his or her interest in the business to an irrevocable trust, the business owner is transferring the asset out of his or her estate at an appreciated value. Any continued appreciation in value will be attributable to the trust rather than to the business owner had the asset passed to the owner's heirs upon his or her death.

To achieve this benefit, the business owner would first recapitalize the entity so as to create a 1 percent Class A voting membership interest and 99 percent Class B nonvoting membership interest. If the entity is a corporation, then the shareholders and board of directors should consent to recapitalize the corporation's shares into Class A voting common stock and Class B nonvoting common stock.[10]

Once the entity is recapitalized, the business owner (now, the "grantor") would gift or sell his or her Class B nonvoting interest, or stock, to a defective grantor trust ("DGT"), also known as an intentionally defective grantor trust. The grantor would retain the Class A voting membership interest or common stock so as to retain control of the entity.

A DGT is a trust in which the grantor pays the income tax on the capital gain and income associated with the assets in the trust despite the fact that the grantor has relinquished ownership of the assets by placing them in the trust.[11]

A DGT is a typical estate planning tool for a business owner who wants his or her family to benefit from the appreciation in value of the membership interest or stock. However, it may not be the right tool if the business owner does not have the funds to pay the income tax associated with income and gain on assets held in the trust. That said, the grantor may borrow funds from the business or the DGT in order to pay the tax.

Although gifting an interest to a DGT is an efficient tax planning tool, a grantor may also wish to:

1. sell a portion of his or her interest to the DGT and
2. also gift a fraction of his or her interest to the DGT.

When a grantor gifts assets out of his or her estate and into a DGT, the grantor is effectively relinquishing ownership of those assets, thus making them inaccessible for the grantor's continued use.

However, an installment sale is a good option for a grantor to whom a return on equity is still necessary during the grantor's lifetime. Additionally, a sale is more desirable as it better protects against Internal Revenue Code Section 2036(a)(2).[12] The assumption here is that the value of the sold interest will outperform the interest rate associated with the installment sale note. Over time, the grantor may forgive all or a portion of the installment note so as

to effectuate a gift to the DGT. In today's low interest rate environment, installment sales have gained in popularity among estate planners and their clients. However, the transaction must be a bona fide sale for adequate consideration.[13]

Therefore, before an installment sale may occur, the DGT should have sufficient assets in the trust in order to pay the interest on the installment sale note. As a result, a grantor typically makes a substantial gift of cash or securities, typically an amount equal to 10 percent of the value of the asset being sold, to the DGT beforehand.[14] This is known as a "seed" gift, and it ensures the trust has substantial assets besides the installment note.

A DGT is also an effective estate planning tool because, although the grantor has relinquished ownership of the assets, the grantor may retain the power to swap an asset out of the trust and substitute the asset for another asset of equal or greater value.[15]

This procedures provides some flexibility when it comes to accessing certain assets placed in trust. The substitution power further allows for effective income tax planning by providing a method to get low tax basis assets that are highly appreciated back into the grantor's estate in order to maximize the step up in basis to fair market value upon his or her death.

By either gifting or selling (or a combination of both) the Class B nonvoting membership interest, the grantor freezes the value of the gifted or sold interest at the time the grantor makes the transfer. Further, the grantor will then apply valuation discounts to value the gifted or sold interest. These valuation discounts are required to determine the fair market value of the particular asset transferred, as they factor into what a willing buyer would pay a willing seller for the asset.

When it comes to closely held businesses, the typical valuation discounts include:

1. a discount for lack of control and
2. a discount for lack of marketability.

The application of these valuation discounts is beneficial to the grantor because such discounts allow a greater transfer out of his or her estate while using less of the applicable exclusion amount and GST exemption amount.

It is important to adequately disclose the value of an asset gifted to a trust in order to:

1. remain compliant with the Service adequate disclosure requirements outlined in Treasury Regulations Section 301.6501 and
2. begin the three-year statute of limitations period that the Service has to contest a gift tax return.

Adequate disclosure allows for the three-year statute of limitations to run on a 709.

It is always recommended that a grantor obtain a professional business valuation by a qualified appraiser that takes valuation discounts into consideration. A professional business valuation may provide more leverage against an assertion from the Service that the adequate disclosure requirements were not met than otherwise would be the case had the grantor not obtained a "qualified" business valuation by a "qualified" appraiser. Contemporaneous appraisals are a deterrent to Internal Revenue Service valuation challenges and penalties.

Finally, the grantor will retain his or her Class A voting membership interest in the entity, which enables the Class A owner to retain administrative control over the entity, as well as flexibility regarding succession planning.

Scenario 2: The Real Estate Owner

Individuals who own real estate portfolios may want to (1) fairly balance the treatment of family members involved in the real estate ventures with those who are not involved, (2) avoid probate, and/or (3) ensure a step up in basis for real estate assets that the owner passes to family members.

While property values have remained strong over the past two years, in part driven by the low interest rates, we have seen in response to the COVID-19 pandemic, the probate process can tie up real estate assets for months, if not years, as well as eat into the gain realized on the sale of these assets.

Transferring property to a limited liability company ("LLC") provides probate relief, and transferring the interest in the LLC to a trust provides tax efficiencies.

Similar to the above-mentioned closely held business owner, the real estate owner may also utilize a combination of an LLC and a DGT:

1. to preserve property values and
2. to ensure such assets are easily accessible by the intended beneficiaries.

To achieve these goals, first, the real estate owner would transfer the property to a holding company, typically a single member LLC with a 1 percent Class A voting membership interest and a 99 percent Class B nonvoting membership interest.

Second, once the property is in the LLC, the owner (the grantor) would gift the Class B nonvoting membership interest to the DGT. Here, real property

appraisals, developed by a qualified appraiser, may prove useful in adequately disclosing the value of the underlying assets of the holding company.

Third, the grantor may then apply valuation discounts for the interest in the LLC that he or she gifted to the DGT, which is best determined by another appraisal.

If a return on equity is also important to the real estate holder, installment sales provide flexibility while still accomplishing a freeze in value. Further, a grantor's substitution power is typically used when real property is transferred directly to a DGT rather than held in an LLC that is then transferred to the DGT.

This procedure is in part due to the fact that the grantor can swap a piece of property with a low basis in the trust for a different piece of property, of equal or greater value, with a higher basis. If the DGT sells the asset with the higher basis, then less gain would be subject to tax than if the DGT retained the lower basis piece of property and then sold it.

The lower basis asset, which would be placed back in the grantor's estate, would then receive a stepped-up basis upon the grantor's death.[16] Still, using an LLC or partnership ownership structure allows flexibility with future highly appreciated real estate, which can be distributed to the DGT with minimal tax consequences. Then, the grantor can use his or her substitution power and swap cash, a note, or another high basis asset to the DGT in exchange for the low basis real estate. The grantor would achieve a new tax basis of fair market value at death, with all the depreciation and taxable gain benefits that may extend to future generations.

It is important to note that the holding company structure provides a level of protection for the members and assets that would otherwise be the case if the real property were transferred directly to the DGT. Thus, the holding company structure is a worthwhile consideration when dealing with property that is owned jointly by multiple family members or investors.

When dealing with a multi-member LLC that is the holder of real estate, the LLC's operating agreement can govern the disposition of a member's membership interest. This means that, in the event a member wants to sell his or her interest, the other members may have the right of first refusal to purchase the seller's membership interest.

For example, let's consider a situation where two siblings form an LLC and then contribute property they held jointly into the LLC. The siblings then each hold a 0.50 percent Class A membership interest and a 49.50 percent Class B nonvoting membership interest.

Sibling 1 takes his or her Class B nonvoting membership interest and gifts it to a DGT for the benefit of his or her children. Sibling 2 does the same with his or her interest and gifts to a DGT established for the benefit of his or her children.

The LLC now has four members, and both the siblings would like their beneficiaries' trust to have the right to acquire the other trust's membership interest, should one decide to sell.

A well-drafted operating agreement that incorporates a right of first refusal for the other members to acquire the membership interest or a buy-sell provision would accomplish the initial members' goal to keep the interest and, therefore, the property, within the family for its continued use. This provision would provide a "market" for the family assets.

The holding company structure preserves the basis increase one would expect to receive upon the death of a partner for the interest that the grantor did not transfer.

In this scenario, with an individual holding the Class A voting membership interest and a DGT holding the Class B nonvoting membership interest, the basis increase would be applicable to the grantor's retained Class A membership interest, not the DGT's Class B nonvoting membership interest.

This holding company structure also provides significant benefits when it comes to valuing the LLC, as valuation discount planning techniques may be utilized. The DGT structure itself, again, provides income tax benefits, as the income from the trust will be taxed to the grantor. With the grantor paying the tax, he or she uses up the assets that remain in the estate.

Due to these income tax benefits and these gift and estate tax benefits, real estate holding companies and DGTs are popular succession planning tools.

Scenario 3: The Owner of Highly Appreciated Marketable Securities

The owner of highly appreciated marketable securities may want family members, or more particularly a spouse, to benefit from these assets in the long term. As such, planning to ensure that family members appropriately utilize the assets is important.

Typically, most marketable securities are held in a brokerage or retirement account. However, the owner can transfer his or her brokerage account to a trust.

While stock values have decreased this year, gifting a brokerage account with depressed stock values that are highly appreciable enables the grantor to utilize less of his or her exemption amounts than

waiting to gift the brokerage account after values have appreciated.

In this scenario, an estate planner may utilize a Spousal Lifetime Access Trust ("SLAT"). SLATs can be beneficial in providing for the owner's spouse and family members.

A SLAT is an irrevocable trust. However, SLATs are unique from other kinds of trusts, such as a DGT, in that the spouse may be a beneficiary of the SLAT. Like a DGT, the income tax from the trust will be paid by the grantor.

Once the owner transfers his or her securities to the SLAT, the trustee, which is typically the spouse benefitting from the SLAT, may make distributions of income and principal to the beneficiaries (i.e., the non-grantor spouse).

Once the non-grantor spouse passes away, the remaining beneficiaries, typically children or grandchildren, will benefit from the trust by either receiving the trust assets outright or in further trust.

A SLAT has an added layer of complexity that is worthy of consideration.

First, the grantor spouse may not split gift the assets transferred to the trust, which means only the grantor spouse's exemption amounts will be utilized, rather than using both spouses' exemption amounts and treating the gift as being made one-half by each. This may be appealing in light of the exclusion amount reducing to pre-TCJA levels beginning in 2026. This is because a couple may use all of one spouse's exemption amount before 2026 while leaving the other spouse's exemption amount intact.

Second, if the non-grantor spouse is serving as both trustee and beneficiary, then the spouse must be limited in making distributions. The non-grantor spouse should only be able to make distributions in accordance with an ascertainable standard, such as health, education, maintenance, or support. Appointing a disinterested third party as trustee would enable the trustee to make discretionary distributions to the beneficiaries.

In addition, in the event each spouse establishes a SLAT in which the non-grantor spouse is a beneficiary, it is imperative the trusts do not run afoul of the reciprocal trust doctrine. Under this doctrine, the Service considers the two trusts to be so interrelated that they were established for the benefit of the grantor.

If the trusts violate the reciprocal trust doctrine, then the assets transferred to the SLAT can be pulled back into the respective grantors' estates. If a married couple is establishing two SLATs, careful planning should be implemented.

Summary and Conclusion

While uncertain economic times may seem like a deterrent to establishing a robust estate plan, such uncertainty also provides a unique opportunity to take advantage of depressed asset values. The fast approaching "sunset" of the TCJA provisions that greatly increased the applicable exclusion amount and GST tax exclusion amount creates a greater urgency to ensure individuals have fully considered and revised their estate plans as applicable.

Each individual's succession planning goals are unique to that person's facts and circumstances. To adequately achieve those goals, it is important to talk with an attorney who is knowledgable regarding the way these goals are intertwined from a tax, business, and estate planning perspective.

The contents of this discussion are presented for informational purposes only and should not be construed as legal advice.

Notes:

1. In 2011, Congress set the applicable exclusion amount at $5,000,000 and is adjusted yearly for inflation. The TCJA increased the amount to $10,000,000, adjusted for inflation.
2. IRS 2017 exclusion amount.
3. IRS 2018 exclusion amount.
4. IRS 2022 exclusion amount.
5. IRS preserve exemption, https://www.irs.gov/newsroom/treasury-irs-making-large-gifts-now-wont-harm-estates-after-2025.
6. Harriet Torry and Anthony DeBarros, "Recession Probability Soars as Inflation Rises," *Wall Street Journal* (June 19, 2022), https://www.wsj.com/articles/recession-probability-soars-as-inflation-worsens-11655631002.
7. Lewis Krauskopf, "Bear Market Confirmed as U.S. Stocks' 2022 Descent Deepens," *Reuters* (June 14, 2022, 1:00 AM), https://www.reuters.com/markets/europe/bear-market-beckons-us-stocks-2022-descent-deepens-2022-06-13/.
8. Treasury department interest rate 1981, 2008, versus now.
9. In this scenario, the entity would likely be a subchapter S corporation.
10. See 26 U.S.C. § 671.
11. See 26 U.S.C. § 2036(a)(2).
12. See 26 U.S.C. § 2036.
13. The requirements of an installment sale are beyond the scope of this discussion.
14. See 26 U.S.C. § 675(4).
15. See 26 U.S.C. § 1014.

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Best Practices includes over 1,200 pages of thought leadership on a wide range of topics, including the valuation of private company securities and intangible assets, valuation for property tax purposes, valuation for ESOPs, fair value measurement for financial accounting purposes, transfer price analysis, and economic damages measurement.

Written by Willamette Management Associates managing directors Robert Reilly and Bob Schweihs, this book provides an anthology of related discussions that address valuation, damages, or transfer price principles. These topics generally are not found in most textbooks. Our focus is on topics that present themselves in client situations where there is a risk—and a cost—of being wrong. Such client situations include complex transactions, tax controversies, and litigation matters. Each of the 72 *Best Practices* chapters presents a discussion of the current thought leadership on the indicated topics.

With a detailed index, this book provides practical guidance to lawyers, valuation practitioners, forensic analysts, and other professionals involved in the practice of valuation, damages, or transfer price analysis.

Published by Valuation Products and Services, the price of this book is $199 (+ shipping & handling). To order the book, visit: **www.willamette.com/best_practices.html**

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Best Practices TABLE OF CONTENTS

Understanding the Grantor Retained Annuity Trust

John H. Sanders Jr. and Dakota Ask

This discussion focuses on the creation and administration of a grantor retained annuity trust (also known as a "GRAT") for estate planning purposes. This discussion describes the basic principles of the GRAT creation. In particular, this discussion explains the many factors that a typical high net worth individual should consider in the process of assessing the pros and cons of the GRAT creation. With regard to the GRAT creation, these factors include both administrative issues and financial issues. Finally, this discussion reviews both the benefits and the risks of the GRAT creation as part of an estate plan.

Introduction

Estate planning can be one of the most challenging and complex aspects of developing a comprehensive financial plan, particularly for high-net-worth individuals. Typically, such individuals have applied considerable effort to amass their wealth. Now, they want to ensure that as much of it as possible is passed down to their heirs and beneficiaries.

Depending on the size of the grantor's estate, the grantor may be responsible for paying a significant amount of tax.

The good news is that individuals in this situation can apply various planning procedures to reduce the transfer taxes they have to pay. Establishing a grantor retained annuity trust, typically referred to simply as a GRAT, is one of the planning procedures that can be considered.

Through the creation of a GRAT, high-net-worth individuals can minimize or eliminate the impact of the gift and estate tax liabilities caused by the transfer of appreciated assets to subsequent generations. A GRAT makes it possible for the high-net-worth individual to "freeze" the value of his or her estate in the near-term future to gift any value appreciation to the beneficiary, who, in turn, avoids tax burdens on the transfer of the estate.

A steady flow of income is distributed to the grantor in accordance with the terms of the trust (in the form of an annual distribution). If an individual owns an asset that he or she believes will increase in value over time (but who does not wish to gift outright immediately), it may make sense to transfer the potential future growth of that asset to the heirs through the use of a GRAT.

What Is an Annuity Trust?

Let us begin by talking about annuities. Annuities play a significant role in GRATs.

An annuity is a financial instrument in which an individual makes an up-front contribution of funds or a selection of assets (such as shares of stock or options) into a designated account.

That account then distributes money back to the individual regularly in installments, immediately, or at some point in the future.

GRAT Basics

A GRAT is a trust established so that individuals and families can transfer wealth to heirs while using little of their lifetime federal gift and estate tax exclusion, if any. This tax-advantaged transfer is possible through the implementation of a GRAT.

In practice, an individual would establish an irrevocable trust with the assistance of an attorney; then the individual transfers assets into that trust. In exchange, the grantor would be eligible to receive annuity payments (at a minimum annual basis) for a predetermined length of time.

The initial transfer, plus any additional interest or appreciation, would be returned to the grantor over the trust's term.

Upon the conclusion of the term, the remainder of the trust would be distributed to the grantor's heirs, either:

1. in the form of an outright gift or
2. as the principal for a subsequent trust.

It is important to remember that the grantor only gets the right to a stream of annuity payments—and not the actual income from the trust. If the trust does not produce an adequate amount of income, the trustee is obligated to make the annuity payment out of the principal.

The amount of a taxable gift is determined by:

1. taking the property's fair market value transferred into the trust and
2. subtracting the value of the grantor's retained interest from that property's value.

Annual payments to the grantor on behalf of the GRAT consist of part of the principal amount and an interest rate. The interest payment is determined using the prevailing interest rate as established by the Internal Revenue Service (the "Service"). This interest rate is referred to as the "Section 7520 rate" or the "hurdle rate."

Theoretically, let's suppose a grantor sets the annuity payments to match the hurdle rate. In that case, all assets underlying the GRAT will have been returned, in total, to the grantor, making the value of the assets worth zero to the beneficiaries.

Throughout the lifetime of the GRAT, the grantor is responsible for paying tax on the income earned by the trust, but the grantor does not pay tax on the annuity payments received.

Ideally, after the GRAT, the property's value transferred into the trust will have appreciated beyond the accumulation of the hurdle rate payments. This procedure allows beneficiaries to receive the assets without incurring heavy tax-transfer burdens.

As the initiator of a GRAT, a grantor assumes that the value of the assets will appreciate to a value greater than the value established by the interest rate. If, however, the value of the assets increase at a rate less than the hurdle interest rate, then the beneficiary of the trust will receive the assets at a depreciated value.

In the event that the GRAT is ended prematurely (i.e., before the terms of GRAT have been fully satisfied), the property is:

1. transferred into the original estate of the grantor and
2. made subject to regular estate taxes.

Therefore, a prospective grantor needs to understand that the benefits of utilizing a GRAT are not assured to the trustee. The use of a GRAT should only be implemented after thoughtful consideration of the implicit risks.

If the trust is set up correctly, any assets still in the trust after the term of the GRAT has expired—including any appreciation greater than the threshold interest rate—will be passed on to the beneficiaries free of gift and estate taxes.

This threshold rate is derived from a rate that the Service prescribes. The rate is variable monthly and fluctuates based on several economic factors; however, the prevailing interest rate at the time of the establishment of the GRAT is the fixed rate at which regular payments are made.

Therefore, for a GRAT to succeed, the assets held within the trust should appreciate by an amount greater than the threshold rate in effect at the time the trust was funded.

When the hurdle rate is low compared to its historical levels, the likelihood that the assets will exceed the hurdle rate may be higher. This could mean significant potential estate tax savings and increased wealth transferred to the beneficiaries.

In creating a GRAT, numerous factors should be considered:

1. The length of the GRAT
2. The funding of the GRAT
3. The appropriate receipt of annuity payments
4 Tax implications
5. The termination of the GRAT

Term of the GRAT

The length of the term for a GRAT can vary. In general, the term typically falls somewhere between 2 and 10 years.

Because a longer-term GRAT can be implemented, a hurdle rate can be fixed for a longer period of time, which may be a potential perk for prospective

grantors. The degree to which one anticipates the value of the trust's assets to increase is a significant factor that should be considered when selecting an appropriate term length.

Compared to speculating over a short time frame, opting for a longer-term GRAT gives the trust more time to appreciate beyond the hurdle rate (assuming favorable market conditions), which increases the likelihood that they will be able to beat said rate.

The more the trust assets can appreciate over an extended period, the higher the remaining balance that will be free of gift and estate tax when passed on to the beneficiaries.

Funding a GRAT

The assets most suitable for contribution to a GRAT include the following:

1. Assets with a current low value compared to their potential future value
2. Assets anticipated to increase in value throughout the GRAT

To the extent that an asset's value can be discounted (because of a lack of marketability or lack of control or certain other constraints), the annuity stream will be computed based on the adjusted (discounted) value of the asset.

This procedure simplifies how the contributed assets may beat the applicable hurdle rate (assuming the annuity is paid with undiscounted assets).

GRATs provide the greatest return on investment when financed with assets that have the potential for considerable appreciation over time (e.g., shares in a family company or pre-IPO equities).

GRATs can also be funded with different types of investable assets. Because of this, GRATs are one of the more flexible financial vehicles available to owners of wealth.

When the GRAT is supported with cash or other investable assets, the process of valuing the assets and transferring those assets is simplified. After the transfer of the assets, the trustee can make investments or reallocations based on the provisions of the trust.

It is difficult and expensive to fund a GRAT with more complicated assets, such as shares in a family-owned company. This is because appraisals may be required if the price for the company shares is not easily identifiable.

Let's consider a scenario in which the grantor has a GRAT that is active and performing well (i.e., assets that have been contributed have appreciated more than the Internal Revenue Service hurdle rate). Under these circumstances, the grantor can consider whether or not it would be beneficial to "lock-in" the appreciation (and, consequently, the benefit to his or her beneficiaries) by exchanging the GRAT assets for assets with lower volatility for the remaining term of the GRAT.

"GRATs are one of the most flexible financial vehicles available to owners of wealth."

When contemplating the funding of a GRAT with a portfolio of assets—such as with shares of a family business *and* with publicly traded equities—it is important to evaluate whether or not it would be more prudent to establish individual GRATs for each category of assets.

If assets are held in separate trusts, it is possible for one GRAT to exceed the required rate of return, while the other GRAT may not be able to do so. If the assets belong to the same trust and one has a negative impact on the other, the combined appreciation of the assets may not be able to exceed the hurdle rate, resulting in an undesired outcome.

After the funding of a GRAT is completed, assets held within the GRAT may be traded for assets held outside of the GRAT. It is possible that this flexibility could be achieved by designating the grantor as the trustee of the trust. Alternatively, the trust document could be drafted by an attorney to include specific language that grants the grantor this authority.

If the GRAT assets do not perform as well as the grantor anticipated, these assets can be removed from the trust and replaced with other assets. Those other assets would be expected to have a higher potential for appreciation.

This procedure may be helpful for the grantor in avoiding certain risks, such as establishing a GRAT when the stock market is trading at historic highs. Such timing may increase the likelihood of a drop in the stock market and a decrease in stock prices occurring during the course of the GRAT.

Conversely, this procedure could also help the grantor realize the full effects of asset appreciation, such as establishing a GRAT when the stock market is trading at low levels.

If the assets held within the GRAT experience rapid appreciation, it is possible to remove such assets and replace them with cash or other assets that are expected to experience low levels of volatility. This strategy can make it possible for the grantor to lock in the rapid appreciation, which can then be passed on to the heirs when the GRAT term ends.

Finally, if the grantor requires access to liquid assets, the grantor can take the liquid assets out of a GRAT and invest the money into illiquid investments instead. However, a current valuation of such assets would need to be considered, among other factors, in this scenario.

Appropriate Receipt of Annuity Payments

It is important to ensure that the annuity payments are appropriately considered in their valuation and that the payments are made on time. The grantor may be able to count—as additional contributions to the GRAT—any annuity payments made by the GRAT that are either incorrect or received late. Because of this, the GRAT may be disqualified, rendering this wealth transfer method ineffective.

The trustee has the responsibility to keep accurate records, including account statements and asset appraisals.

When making the appropriate payments for an annuity, a grantor can receive either:

1. monetary compensation or
2. a portion of the trust assets.

Tax Implications

During the GRAT term, the GRAT's income tax liability is passed to the grantor for federal income tax purposes. During the remainder of the term, the tax liability will either:

1. pass through to the grantor or
2. be paid by the trust.

This consideration depends on the structure of the remaining term. It allows the assets in the GRAT to appreciate during the term of the GRAT without incurring any income tax liability. However, this consideration does not allow the grantor to avoid paying income taxes on any appreciation realized during that period.

Termination of a GRAT

After the term of the GRAT, any assets that have been held in trust for the beneficiaries will either:

1. be given to them in their entirety or
2. continue to be held in trust for their benefit.

If several rolling GRATs have been established, the grantor may, for administrative convenience, consolidate the balances of these trusts into a single trust.

For income tax purposes, the trust can also be treated as a grantor trust, which means that the grantor will:

1. continue to be responsible for paying the income and
2. see an additional reduction in his or her taxable estate.

It is also possible for the trust to acquire new assets, sell existing assets, or receive distributions without triggering the realization of ordinary income or capital gains. The assets held in the trust can be made accessible to whomever the trustee selects, subject to as many or as few restrictions as the trust documents determine.

Benefits and Risks of Using a GRAT

Benefits of a GRAT

The creation of a GRAT can result in several advantages. One of the primary benefits of purchasing an annuity is that it can guarantee a certain amount of money during retirement for those who require it.

The primary advantage of creating a GRAT is the possibility of transferring large sums of money to a beneficiary without paying any (or only a minimal amount of) gift tax.

Gifting is an important part of estate planning. This is because gifting enables the grantor to transfer assets to a beneficiary free of any tax liability—so long as the value of the gift does not exceed the amount exempt from federal gift tax.

The exemption amount is $16,000 in 2022, meaning that an individual can make up to that amount annually without paying gift taxes on that income. However, gift taxes are owed on amounts that are given that are greater than $16,000.

It is possible to transfer much more than $16,000 to a beneficiary without paying gift taxes. That would occur if the grantor incorporates a GRAT into the grantor's estate planning strategy. Again, this is a benefit for individuals with larger estates—that is, individuals who are wealthy enough to take advantage of it.

The GRAT makes it possible for individuals to transfer more valuable assets or properties in a shorter time. Also, the GRAT allows them to avoid or significantly reduce the gift and estate tax liability that a transfer of this magnitude would typically incur.

Risks of a GRAT

The utilization of a GRAT is not without risks. When a grantor establishes a GRAT, he or she is also responsible for deciding how long the trust will last. After the period has run its course, the beneficiaries will be given the remaining portion of the asset transfer.

If the grantor passes away before the period of the trust is up, then all of the assets in the trust (1) revert to the grantor and (2) are included in the grantor's taxable estate.

Because of this, grantor considerations of the length of the term may include some element of risk. More extended periods provide more time for the grantor's assets to appreciate, resulting in a substantial capital gain. This is the primary motivation for creating a GRAT in the first place.

On the other hand, the longer the period is—for instance, 20 years—the greater the likelihood that the grantor's health may deteriorate—and the greater the possibility that the grantor would not live long enough to see the conclusion of the term.

Because the grantor often only avoids gift tax on asset appreciation, it is a best practice to only populate the GRATs with high-yielding assets, like shares of stock. This is because the grantor only avoids gift tax on asset appreciation.

If the grantor does not anticipate a considerable increase in value for these assets in the foreseeable future, creating this kind of trust may not be financially beneficial.

Let's assume that grantor considers the time and resources needed to establish a GRAT as being too great of a burden. In that case, it may be that the benefits of establishing a GRAT may not justify the costs, and the grantor may be better off donating the monies or assets through more conventional channels.

Lastly, the cost basis that the grantor had in the asset is preserved in the donated asset. When the beneficiaries eventually sell the asset, they will be required to pay capital gain taxes on the entire gain associated with the property—not just on the gain they realized when they received the asset.

These capital gain taxes will be paid in addition to the gain they realized when they received the asset. The recipients may be responsible for paying large income taxes on the donated property.

Summary and Conclusion

A GRAT is a beneficial financial instrument available for individuals who wish to protect their wealth for the benefit of their heirs. GRATS offer individuals a vehicle to mitigate tax burdens in the transfer of their estate.

When executed appropriately, the GRAT bypasses financial obligations on behalf of the transferee, who would otherwise be liable to pay estate taxes (which may be considerably large sums in the case of larger estates). Moreover, the beneficiary is allowed to fully realize the appreciation in the value of the grantor's estate.

The GRAT should be created only after careful consideration of the many factors and complexities that may influence or complicate the trust.

First, the grantor should consider the appropriate length of the GRAT. What is the appropriate duration for the trust which allows the beneficiary to entirely realize its benefits?

Second, the grantor should consider the outlook of the assets and decide on the optimal duration for which these assets will realize their potential value.

Third, the grantor should also make the sobering consideration as to whether he or she will be around to see it fully gifted to the heirs. In making these decisions, the grantor should weigh the judgment of potential value against the appropriate hurdle rate.

The grantor should decide how to fund the trust, which assets he or she wishes to put into the trust, and how the trust is administered. Should the grantor create separate trusts for various asset classes?

In addition, the grantor should be prepared to adapt to changing circumstances. The flexibility of the GRAT is one of the important features that the grantor should take advantage of.

In times of economic uncertainty or prosperity, a grantor may make the necessary adjustments to reflect the trust's goals.

Another consideration is setting the appropriate annuity amount, as a miscalculation of the trust's ability to make these payments in regular installments may jeopardize the effectiveness of the trust.

In deciding whether or not to create a GRAT, an individual should weigh the prospective benefits and risks. If applied to its full capabilities, the GRAT allows the individual to pass down the advantages of asset ownership while avoiding some of the inconveniences of the asset transfer.

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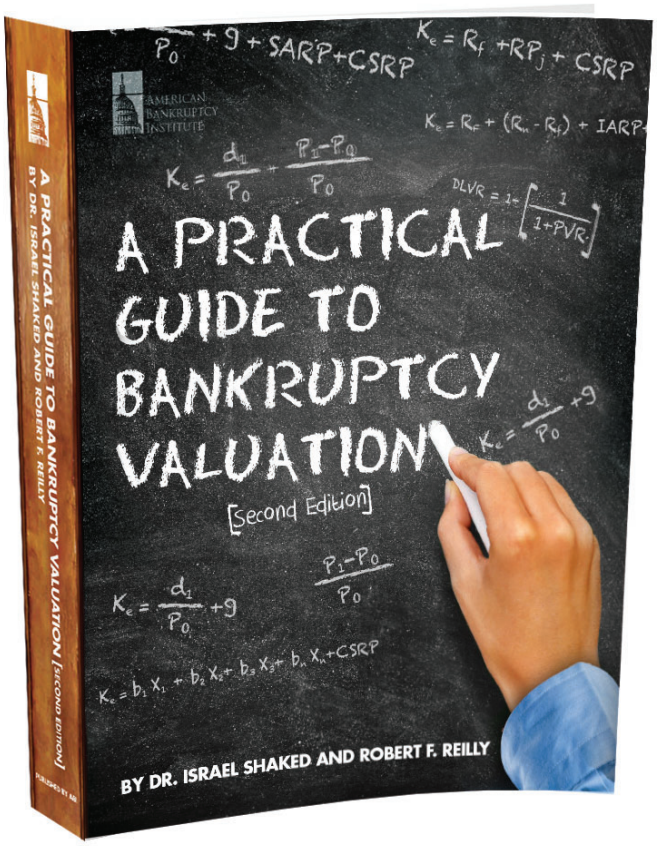

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A CITIZENS COMPANY

A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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A CITIZENS COMPANY

Disguised Dividends and Shareholder/ Employee Compensation

Eliza Jones and Lisa H. Tran

The reasonableness of shareholder/employee compensation in a closely held corporation is an important and often controversial issue. The Internal Revenue Service sometimes alleges that shareholder dividend payments are disguised as a management fee, executive bonus, or "catch-up" payment. In whatever form the shareholder/employee compensation is reported, closely held company owners often rely on analysts to help them determine a reasonable level of executive compensation in order to respond to Internal Revenue Service challenges. This discussion (1) reviews statutory authority and judicial precedent regarding reasonable compensation for shareholder/employees and (2) summarizes some of the shareholder/employee compensation issues from recent judicial decisions.

Introduction

Internal Revenue Code Section 162(a) allows expenses incurred or paid by a business in a taxable year to be deducted for U.S. federal income tax purposes. Such income tax deduction may include reasonable compensation for services rendered.

If the business is a closely held corporation and the persons receiving the compensation are shareholders, the payments (which may include a salary, bonus, or other compensation paid to shareholder/employees) may be subject to close scrutiny by the Internal Revenue Service (the "Service").

The Service may want to determine if the income tax deduction represents:

1. market-based compensation for the services actually rendered or
2. a disguised distribution of company profits to shareholders.

There can be significant tax-related consequences (e.g., a tax understatement penalty associated with the deduction of an unreasonable amount of shareholder/employee compensation) associated with unreasonable shareholder/employee compensation tax deductions.

In some cases where the shareholder(s) owns several related businesses, the compensation may be presented in the form of a management fee that one entity charges to another related entity for consulting services provided by the shareholder/employee(s).

This form of compensation issue arose in the matter of *Aspro, Inc. v. Commissioner*.[1] In this decision, the U.S. Tax Court supported the Service's position and disallowed all deductions for management fees comprised of compensation paid to all three shareholder/employees of the private corporation over a three-year period.

Executive compensation in the form of a "catch-up" payment may also be scrutinized by the Service as a nondeductible dividend. This form of compensation issue arose in the matter of *Clary Hood, Inc. v. Commissioner.*[2]

In this decision, the Tax Court reduced the executive compensation that the taxpayer

corporation could claim as a business expense over a two-year period.

Reasonable Compensation Guidance

Compensation paid to shareholder/employees is often scrutinized by the Service. Shareholder/employees of closely held C corporations may have an incentive to pay themselves higher salaries in order for the private corporation to avoid paying federal income taxes on its operating profit.

In addition, the Service often claims that excess compensation represents a disguised—and nondeductible—dividend to the shareholder/employees.

Section 162(a) provides that executive compensation is deductible as a business expense if it is:

1. reasonable in amount and
2. based on services actually rendered.[3]

For shareholder/employee compensation to qualify as employee compensation, Treasury Regulation 1.162.7 lists the following four requirements. Shareholder/employee compensation should be:

1. an ordinary and necessary expense,
2. reasonable in amount,
3. based on services actually rendered, and
4. actually paid or incurred by the taxpayer corporation.[4]

According to Regulation 1.162-7, a taxpayer corporation may deduct a shareholder/employee compensation payment that is based on performance using a percentage formula.

Shareholder/employee compensation based on a percentage formula may be:

1. a percent of corporation revenue,
2. a percent of corporation earnings, or
3. a percent of some corporation income measure.

In addition to the Treasury Regulations on the reasonableness of shareholder/employee compensation, taxpayer companies also can review the judicial precedent that considers the reasonableness of executive compensation.

Factors to consider in determining the reasonableness of shareholder/employee compensation were presented by the Court of Appeals years ago in the *Mayson Manufacturing Company v. Commissioner* decision.[5]

The *Mayson* decision listed eight factors that may be evaluated in determining the reasonableness of compensation paid to a shareholder/employee.

In the 1996 *Pulsar Components International, Inc. v. Commissioner* decision,[6] the Tax Court expanded the *Mayson* factors to include the following:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the employer's business
4. A comparison of salaries paid with the employer's gross and net income
5. The prevailing general economic conditions and the background of the industry
6. A comparison of salaries with distributions to officers and retained earnings and the employer's dividend history
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the employer as to all employees
9. The amount of compensation paid to the particular employee in previous years
10. The employer's financial condition
11. Whether the employer and employee dealt at arm's length
12. Whether the employee guaranteed the employer's debt
13. Whether the employer offered a pension plan or profit sharing plan to its employees
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

In the *Trucks, Inc. v. U.S.* decision,[7] the District Court considered the following factors in its assessment of the reasonableness of shareholder/employee compensation for a closely held C corporation:

1. Training and qualifications
2. Responsibilities and number of hours worked
3. Results of employee's efforts
4. Ratio of compensation to company growth (before salaries and tax)
5. Absence of fringe benefits available to executives in comparable companies

6. Responsibility for inception and/or success
7. Correlation between compensation and ownership interest

Additionally, the federal courts have increasingly applied the independent investor test in shareholder/employee reasonable compensation disputes. The Tax Court first applied what is called the independent investor test in 1984 in the *Elliotts, Inc. v. Commissioner*[8] decision.

In the independent investor test, the Tax Court considered whether an independent investor would pay the shareholder/employee the same compensation he or she was receiving from the company.

The Tax Court based its independent investor consideration on (1) the actual rate of return on owners' equity for the subject company compared to (2) a market-derived required rate of return on owners' equity.

The following discussion summarizes recent judicial decisions related to the determination of the reasonableness of shareholder/employee compensation paid by closely held corporations.

Compensation from Related Entities

Aspro, Inc.

In *Aspro, Inc. v. Commissioner*, the Tax Court considered the issue of shareholder/employee compensation deducted as management fees.

For the tax years 2012 to 2014, Aspro, Inc. ("Aspro"), paid management fees to its three shareholders:

1. Milton Dakovich (owning 20 percent of the Aspro stock)
2. Jackson Enterprises Corp. (owning 40 percent of the Aspro stock)
3. Manatt's Enterprises, Ltd. (owning 40 percent of the Aspro stock)

A C corporation, Aspro operated an asphalt paving business with two asphalt plants located in Waterloo, Iowa, and it employed 66 to 75 employees. Aspro generated revenue mainly from government contracts.

Milton Dakovich ("Dakovich") served as Aspro's president. His job responsibilities included project oversight, identifying and bidding on projects, and making equipment and personnel decisions.

Dakovich's compensation for his services at Aspro included a base salary, a bonus, management fees, and director fees. The Aspro board of directors set the amount of the management fees.

An S corporation, Jackson Enterprises Corp. ("JEC") was a holding company with no operations or employees. Stephen Jackson ("Jackson") served as its president.

JEC owned 98 percent of Cedar Valley Corp. ("CVC"), which provided concrete paving services in Iowa, Missouri, and Nebraska. Owned by Jeff Rost ("Rost"), Cedar Valley Management Corp. provided management services to CVC, and it employed Jackson, Rost, Virginia Robinson, William Calderwood, and Michael Cornelius.

According to testimony for the taxpayer (i.e., Aspro), these individuals provided services (e.g., advice on contract bids and equipment purchases) to Aspro and Dakovich at one time or another during the years in question.

A C corporation, Manatt's Enterprises, Ltd. ("ME"), operated a farming operation in Iowa. ME did not provide asphalt or road paving services. Tim Manatt ("Manatt") served as ME's president. Manatt was not an officer of Aspro and did not enter into any written consulting or management services agreement with Aspro. At times, Manatt would advise Dakovich on certain business matters.

Exhibit 1 presents (1) the management fees paid to the three shareholders and (2) the Aspro reported revenue and net income for the years in question.

In testing whether shareholder/employee compensation can be deductible as a business expense and to ensure that the payments are not disguised distributions, the Tax Court considered if the compensation represented payments purely for services rendered.

In this case, the Tax Court found the following:

1. Aspro made no distributions to its three shareholders but paid management fees each year.

   In fact, the Tax Court found no evidence that Aspro ever made distributions to its three shareholders during its entire corporate history.
2. The two largest shareholders (i.e., JEC and ME) received equal payments in management fees, and the percentages of the management fees corresponded approximately to the respective ownership interest in Aspro by each shareholder.

This supports the inference that the managements fees paid actually represented distributions.

3. Aspro paid management fees as lump sums at the end of the tax year rather than throughout the year as the services were performed.
4. Aspro paid management fees to JEC and ME, instead of the actual entities or individuals performing the services.
5. Aspro reported negligible taxable income after the payment of the management fees. Sometimes, a court gauges if a corporation is disguising the distribution of dividends as compensation by considering the compensation a percentage of taxable income before deducting the compensation in question.

   The management fees paid in 2012, 2013, and 2014 reduced Aspro's taxable income by 89 percent, 86 percent, and 77 percent, respectively.
6. The Tax Court could not find any written management or consulting services agreements between Aspro and any of its three shareholders. No management fee rate or billing structure was negotiated or agreed to by the shareholders and Aspro.

   Further, Aspro did not receive any invoices for any services provided by the shareholders.
7. The management fees were determined by the Aspro board of directors near the end of the tax year when the board had a better idea of the company's financial performance for the year.

   The board minutes did not indicate how the management fee amounts were determined.
8. Aspro provided no evidence to demonstrate what companies comparable to Aspro would pay for such services provided by the three shareholders.

   Reasonable compensation is only the amount that would ordinarily be paid for like services by like enterprises under like circumstances.[9]

Exhibit 1
Aspro, Inc. v. Commissioner
Management Fees and Reported Company Financials

Tax Years	Aspro Revenue ($000)	Aspro Net Income ($000)	Mgmt. Fees Paid to Dakovich	Mgmt. Fees Paid to JEC	Mgmt. Fees Paid to ME
2014	23,587.0	1,103.1	$200,000	$800,000	$800,000
2013	22,478.5	-131.7	$150,000	$800,000	$800,000
2012	25,926.4	192.6	$166,000	$500,000	$500,000

In assessing whether the management fee paid to Dakovich was reasonable, the Tax Court relied on the Service's expert witness, Ken Nunes ("Nunes"), a chartered financial analyst and business valuation analyst.

Nunes relied on compensation data from the 2012 *Executive Compensation Survey of Contractors* published by PAS, Inc., for companies operating in the construction industry similar in size and location of operations to Aspro.

The Nunes expert report concluded that Dakovich was overcompensated relative to other chief executive officers ("CEOs") employed in the relevant industry.

In addition, Nunes provided data and analysis that indicated that the Aspro compensation structure did not allow for adequate shareholder returns. After payment of the management fees, Aspro's operating margins were well below those of its industry peers.

Aspro failed to present evidence or expert testimony showing that an independent investor would receive a reasonable return on an investment in Aspro with the existing shareholder compensation structure.

Since Aspro was unable to provide documentation supporting the nature of the management fees and did not retain an analyst to argue for the reasonableness of the compensation paid to Dakovich, this case was an easy victory for the Service.

The Tax Court supported the Service's position to disallow all the reported management fees, thereby causing Aspro to owe income tax deficiencies for the years in question.

Compensation That Includes Catch-Up Pay

Clary Hood, Inc.

In *Clary Hood, Inc. v. Commissioner*, the Service determined that for tax years 2015 and 2016, the

amount of compensation paid to CEO Clary Hood ("Hood") exceeded reasonable compensation.

In this case, the Tax Court applied a multifactor assessment to determine the reasonableness of shareholder employee compensation based on the precedent of the U.S. Court of Appeals for the Fourth Circuit.

If appealed, this case would go to the Court of Appeals for the Fourth Circuit. At the date of this trial, the Court of Appeals had not adopted any application of the independent investor test.

In 1980, Hood and his wife founded Clary Hood, Inc. ("CHI"), a C corporation providing land grading and excavation services for construction projects in the South Carolina region. Hood and his wife were the CHI sole shareholders and members of the board of directors.

The company expanded from only 2 employees to 150 employees and generated nearly $70 million in revenue by the 2016 tax year.

From 2000 to 2010, CHI experienced modest growth, achieving less than $1 million in net income in most years. During the great recession (from 2009 to 2011), the company survived due to Hood's decisions to:

1. conserve cash;
2. temporarily reduce employee pay;
3. withhold Hood's salary, when necessary; and
4. sell equipment to generate cash.

In 2012, Hood made the unilateral decision to transition away from providing site grading work for Walmart, Inc; this was one of the CHI's most significant and consistent sources of revenue.

Though producing lower operating margins due to bidding and pricing pressures, these Walmart projects generally accounted for more than 20 percent of company revenue between 1999 and 2011.

Beginning in July 2011, CHI began diversifying its customer base by transitioning from retail-related projects to the commercial and industrial market sectors.

Fortunately, CHI won the bid for a sizable project in North Carolina that generated over $30 million in revenue and became the most significant and profitable project for the company.

Through Hood's efforts, CHI won two additional significant projects through 2014. Accordingly, the CHI revenue increased from $20.6 million in 2010 to $68.8 million in 2016.

While Hood held various job titles at CHI, his responsibilities at the company did not change much. These responsibilities included the following:

1. Equipment oversight
2. Hiring, training, and supervision of mechanics
3. Supervision and inspection of job sites
4. Preparation and review of job bids
5. Negotiation of job bids
6. Setting employee compensation
7. Acquisition of bonding

In addition to his job responsibilities at CHI, Hood and his wife would personally guarantee any claims the bonding companies had against CHI and guaranteed payment of some of the company's loans, credit lines, and capital leases.

Hood's compensation was not set by any employment contract or agreement, and sometimes varied based on the financial well-being of the company.

The CHI board of directors set the amount of Hood's annual compensation, including bonuses.

In 2014, the CHI chief financial officer, Chris Phillips ("Phillips") believed that Hood was undercompensated in prior years and sought advice on Hood's future compensation structure.

Using compensation data from PAS, Inc., and a 2010 Construction Financial Managers Association survey, Hood, Phillips, and CHI's outside accountant agreed that Hood should receive $5 million in bonuses going forward for services provided in previous years.

Exhibit 2 presents the CHI reported revenue and earnings before taxes, and compensation for Hood as CEO.

The total compensation that was determined for Hood included a base salary, an annual bonus, an annual fee for bonding guarantees, and an annual debt guaranty fee.

Exhibit 2
Clary Hood, Inc. v. Commissioner
Compensation and Reported Company Financials

Tax Years	Clary Hood Revenue ($Mil.)	Clary Hood EBT ($Mil.)	CEO Base Salary ($)	CEO Bonus ($)	Total CEO Compensation ($)
2016	68.8	14.5	196,500	5,000,000	5,196,500
2015	44.1	7.1	168,559	5,000,000	5,168,559
2014	34.1	8.3	181,538	1,500,000	1,681,538
2013	42.8	7.4	381,707	1,000,000	1,381,707
2012	23.7	2.3	21,100	200,000	221,100
2011	15.6	loss	83,400	35,000	118,400
2010	20.6	loss	132,500	0	132,500
2009	27.8	loss	130,000	0	130,000
2008	38.4	2.9	130,000	320,981	450,981

Multifactor Approach

The Tax Court accepted that Hood was a significant contributing factor to the CHI financial success for the years in question and that Hood was also entitled to some degree of additional compensation for prior services rendered. However, the Tax Court questioned what level of executive compensation was reasonable as a deduction for a business expense.

In following the guidance of the U.S. Court of Appeals for the Fourth Circuit, the Tax Court considered multiple factors in determining the amount of reasonable compensation for Hood, including Hood's background and qualifications.

Hood had over 50 years of relevant work experience in land grading and excavation and established an excellent reputation for CHI in the market.

The Tax Court considered Hood's job responsibilities and the total hours he worked at CHI. Hood was the driving force behind the company's success and typically worked 60–70 hours per week, including weekends.

The Tax Court considered the size and complexity of the CHI business. CHI specialized in land grading and excavation, which is more complex than providing general construction services. Through Hood's expertise and contribution, CHI became an important player in a niche market.

The Tax Court considered whether prevailing economic conditions or Hood's efforts contributed to the success of the company.

The CHI outside accountant testified that CHI was his most profitable client between 2013 and 2016 due to Hood's contributions, which ensured the survival of the company through the great recession.

The Tax Court considered Hood's compensation with distributions to stockholders. CHI reported a significant increase in profitability from 2013 to 2016, yet never declared or paid *any* cash dividends.

Hood was a controlling shareholder of CHI. Yet, CHI elected to reward Hood for his efforts with a significant cash bonus rather than through a dividend payment.

The Tax Court considered the CHI compensation policy for all its employees. CHI had no structured system for establishing the compensation of its nonshareholder employees. Hood personally determined the compensation of the CHI executives based on his subjective beliefs.

Hood's total compensation in 2015 and 2016 represented almost 90 percent of the total compensation of the other CHI executives who worked nearly the same number of hours as Hood.

Finally, the Tax Court considered prevailing market-based executive compensation for comparable positions in companies comparable to CHI. For this, the Court found the Service's expert witness, David Fuller ("Fuller"), founder of Value, Inc., a financial and valuation consulting firm, to be credible.

The Fuller report provided data and analysis regarding what companies similar to CHI would pay in compensation for Hood's services. The Fuller

report relied upon the Risk Management Association data for executive compensation for the site preparation contractors industry, and compensation data provided by PAS, Inc., for the construction industry.

The Fuller report concluded that the amount of reasonable compensation for Hood should be $3,681,269 in 2015 and $1,362,831 in 2016.

The Tax Court assigned little or no weight to the testimonies of the CHI expert witnesses, Samuel Kursh of BLDS, LLC ("BLDS"), and Theodore Sharp, a senior partner at Korn Ferry.

The Tax Court found both experts' reports lacking in support for its calculations and conclusions and in the disclosure of data sources relied upon.

The BLDS report compared CHI, a private regional specialty construction firm, to significantly larger-size public companies with diversified operations. The Korn Ferry report relied on compensation survey data for companies with up to $500 million in annual revenue.

While the Tax Court agreed that Hood should be compensated appropriately for his contributions to the success of CHI, including back pay for services rendered in prior years, the Tax Court concluded that CHI failed to establish that the amounts deducted as compensation in 2015 and 2016 were reasonable.

Relying on the Fuller report, the Tax Court concluded that the amount of reasonable compensation for Hood should be $3,681,269 in 2015 and $1,362,831 in 2016.

Summary and Conclusion

The reasonableness of shareholder/employee compensation in a closely held corporation is an important and often controversial issue. Compensation that is considered reasonable by the corporate taxpayer may be considered unreasonable by the Service.

This is because a shareholder /employee may be motivated to deviate from arm's-length compensation in order to minimize the income tax deduction attributable to the closely held corporation.

The Service may allege that excess shareholder/employee compensation:

1. absorbs taxable corporate income and
2. represents a disguised nondeductible dividend to the shareholder.

The Service may allege that excess shareholder/employee compensation may be disguised as a management fee or as back pay.

The tax consequences associated with unreasonable shareholder/employee compensation may be significant. The taxpayer corporation bears the burden of proof that the reasonable compensation determination by the Service is incorrect.

Determining the reasonableness of shareholder/employee compensation can be a challenging task. Over the years, the Service and the courts have developed numerous guidelines to enable corporate taxpayers and their consultants to determine the reasonableness of shareholder/employee compensation.

In whatever form the shareholder/employee pay is reported, closely held companies may rely on analysts to help them determine a reasonable level of executive compensation in order to minimize the risk of challenge from the Service.

In *Aspro, Inc. v. Commissioner*, the corporate taxpayer did not employ an analyst to determine reasonable compensation. In *Clary Hood, Inc. v. Commissioner*, the corporate taxpayer employed two analysts who produced expert reports and compensation conclusions that the Tax Court considered to be unreliable. In both cases, the Service prevailed on its claims.

Notes:

1. Aspro, Inc. v. Commissioner, T.C. Memo. 2021-8 (Jan. 21, 2021).
2. Clary Hood, Inc. v. Commissioner, T.C. Memo. 2022-15 (Mar. 2, 2022).
3. Internal Revenue Code Section 162(a)(1).
4. Treasury Regulation 1.162-7.
5. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).
6. Pulsar Components International, Inc. v. Commissioner, T.C. Memo. 1996-129 (Mar. 14, 1996).
7. Trucks, Inc. v. U.S., 588 F. Supp. 638 (D.C. Neb. 1984).
8. Elliotts, Inc. v. Commissioner, T.C. Memo. 1984-516 (Sept. 27, 1984).
9. Sec. 1.162-7(b)(3), Income Tax Regs.

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Valuation of Promissory Notes for Transfer Tax Purposes

Timothy C. Ladd

To estimate the fair market value of a promissory note, the valuation analyst typically considers the professional guidance provided by the Internal Revenue Service, particularly in Revenue Ruling 67-276. Revenue Ruling 67-276 states "the existence of an over-the-counter market for such securities and the quotations and opinions of value provided by brokers and real estate appraisers will not be accepted as conclusive evidence of the fair market value of such securities." This Revenue Ruling also indicates that the analyst who estimates the fair market value of a promissory note should consider (1) all available financial data and (2) all relevant factors affecting the fair market value.[1] *However, this professional guidance may be too general for the individual analyst developing a particular promissory note valuation. First, this discussion summarizes relevant regulations and judicial decisions with regard to transfer-tax-related promissory note valuation. Second, this discussion summarizes the generally accepted promissory note valuation methodologies considered both in relevant judicial decisions and in the professional valuation literature.*

Introduction

Estates often seek to structure promissory notes to secure needed liquidity for the grantor's relatives. When a family member—or a related entity, such as a trust—has poor credit or requires capital and cannot get a loan from a bank or similar institution, intrafamily loans and promissory notes can provide the needed liquidity.

Loans and promissory notes differ slightly. These differences are summarized below.

Loan agreements are evidenced by the signing of a loan agreement. A loan agreement is effectively a contract between a lender and a borrower. The loan agreement stipulates the terms and conditions of the loan—along with the rights and obligations of both the lender and the borrower.

A promissory note is a written promise from the borrower to pay a stated amount of principal and interest until a maturity date.

A promissory note can also be characterized as a negotiable instrument. A promissory note, as opposed to a loan agreement, benefits the lender with some degree of liquidity. A promissory note can be transferred without the consent of the borrower unless the promissory note restricts a transfer.

This discussion focuses on estimating the fair market value of promissory notes. The valuation methodology discussed can also be applied in estimating the fair market value of loan agreements.

This discussion also addresses numerous issues concerning the fair market value valuation of promissory notes for transfer tax purposes.

First, this discussion examines relevant gift and estate tax regulations regarding the fair market value valuation of promissory notes.

Second, this discussion analyzes relevant judicial decisions and summarizes note valuation methodologies considered in the relevant court cases and in the valuation professional literature.

Finally, this discussion recommends financial data and relevant factors that valuation analysts may consider in estimating the fair market value of intrafamily notes within the meaning of Internal Revenue Service Technical Advice Memorandum ("TAM") 8229001.

Bona Fide Loans

The Internal Revenue Service (the "Service") may treat a transfer of property or assets between family members as a gift—even though a promissory note was given in return for the transfer. If it appears to the Service that the loan would likely never be repaid, then the Service may regard the transfer as a gift.

Transfers between family members are treated as gifts unless the transferor can prove the receipt of "an adequate and full consideration in money or money's worth."[2]

However, taxpayers may rebut the Service's position regarding a gift by demonstrating that, at the time of the transfer, the transferor had:

1. a real expectation of repayment and
2. an intention to enforce the loan.

In the *Estate of Lockett v. Commissioner*, when the transferor made a demand for payment, the promissory notes transferred between family members were treated as loans.[3,4]

The U.S. Tax Court considered the following factors to determine:

1. a real expectation of repayment and
2. an intention to enforce the loan.

The following nine factors were originally listed in the Tax Court memorandum decision *Miller v. Commissioner:*[5]

1. Whether there was a promissory note or other evidence of indebtedness
2. Whether interest was charged
3. Whether there was any security or collateral
4. Whether there was a fixed maturity date
5. Whether a demand for repayment was made
6. Whether any actual repayment was made
7. Whether the transferee had the ability to repay
8. Whether any records maintained by the transferor and/or the transferee reflected the transaction as a loan
9. Whether the manner in which the transaction was reported for federal tax purposes is consistent with a loan

Miller v. Commissioner involved a non-interest-bearing unsecured demand note for which a taxpayer made transfers to her son in return.[6]

In the *Miller* decision, the Tax Court concluded that the transfer was a gift and not a bona fide loan, based on the fact that "the mere promise to pay a sum of money in the future accompanied by an implied understanding that such promise will not be enforced is not afforded significance for federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money's worth."[7]

Relevant Judicial Decisions Related to Note Valuation

Once a promissory note is determined to be a gift or included in an estate, a valuation analyst may need to estimate the fair market value of the note for transfer tax compliance purposes.

Treasury Regulation Section 1.148-5(d) defines the fair market value of an investment as "the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's length transaction."

Regulations Sections 20.2031-(b) and 25.2501-1 define fair market value as "the price at which 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."

For gift or estate tax purposes, the fair market value of a promissory note is "the sum of the unpaid amount of principal and accrued interest to the date of gift or death, unless the evidence shows that the note is worth less than the unpaid amount or is uncollectible either in whole or in part."[8]

A taxpayer assumes the burden of proof to submit compelling evidence that the promissory note is worth less than the face value plus accrued interest.[9]

Judicial precedent may provide relevant professional guidance to valuation analysts engaged in developing the fair market value valuation of promissory notes.

There is limited professional guidance provided by the Service concerning appropriate market rates, discounts, or methodologies—except for Revenue Ruling 67-276. Revenue Ruling 67-276 indicates

that market surveys, quotations, and opinions of brokers and real estate appraisers will not be accepted as conclusive evidence of fair market value.[10]

Bernat v. Commissioner

In the Tax Court memorandum decision *Bernat v. Commissioner*, Barbara Given and Julian Bernat were the executors of the estate of Meyer B. Berkman ("Berkman").

Berkman made several transfers to his daughter and son-in-law between 1968 and 1970 in exchange for five promissory notes with a total face amount of $275,000.[11]

Each of the five promissory notes was a 20-year unsecured note, bearing 6 percent annual interest, payable monthly, with no payment of the principal until the maturity of the note. Upon maturity, the full balance of the principal was due.

At the time of his death in 1974, Berkman owned these five promissory notes and had not reported the transfers as taxable gifts.

In defining the term "taxable gift," the Tax Court acknowledged that, with respect to Section 2512(b), "where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed as a gift."

However, the Tax Court also considered that an exception to Section 2512 includes all bona fide transfers at arm's length in which no donative intent presents.

Finally, the Tax Court concluded that the decedent's transfers were not at arm's length within the meaning of Regulations Section 25.2512-8.[12]

The following factors were considered by the Tax Court:

1. Berkman was over 75 years old at the time of the initial transfers in exchange for promissory notes due in 20 years.
2. Berkman took no security on these notes.
3. The promissory notes did not require any principal payments until maturity.
4. In his will, Berkman directed that all his property be divided equally between his daughters.

After careful consideration, the Tax Court concluded that the estate had not provided compelling evidence that the transfers were at arm's length and free of donative intent. Accordingly, the court determined the amount of gift as the difference between:

1. the amount of the loans and
2. the fair market value of the promissory notes under Section 2512(a) and (b).[13]

To calculate the fair market value of the promissory notes, the Tax Court considered the following factors:

1. The rate of interest available in the market (i.e., the U.S. prime rate) compared to the interest rate of the notes
2. The date of maturity
3. The lack of security
4. The solvency of the debtors

Exhibit 1 presents (1) the fair market value of the first four promissory notes and (2) the amounts of the gifts. Issued in 1972 within three years of the date of death, the fifth note was included in the decedent's estate—and excluded from Exhibit 1.

The Tax Court also concluded that the promissory notes were to be included in the decedent's gross estate at fair market value as of the date of his death. This was because the decedent died owning the five promissory notes.[14]

The Tax Court considered the valuation of notes under Regulations Section 20.2031-4 as follows: "[T]he fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death unless the executor establishes that the value is lower or that the notes are worthless."

Exhibit 2 presents the fair market value of the five promissory notes on the date of the decedent's death, including accrued interest.

Certain of the transfer of $55,000 to the daughter and son-in-law within three years of the decedent's death, the court concluded that this amount was to be included in the decedent's gross estate under Section 2035.[15]

However, the transfer was applied to an exception of Section 2035, where a bona fide transaction for adequate and full consideration exists.[16]

From the promissory note, the decedent received 6.00 percent interest at a time when the U.S. prime rate was only 4.75 percent. Considering the higher interest rate of the note than the market provided, the court concluded that the loan resulted in a bona fide transfer for adequate and full consideration, and the transfer was not includable in the decedent's gross estate.

Smith v. United States

The matter of *Smith v. United States* involved the valuation of a promissory note with an original principal balance of $10.3 million, which was payable over a period of 20 years.

The annual principal payments were $515,600 along with 6 percent simple interest computed beginning at inception to the date of payment.[17]

The accrued interest resulted in progressively larger payments due to the passage of time. There was a dispute regarding the promissory notes valued by the decedent on the date of death. The dispute was litigated in *Smith v. United States.*[18] Evelyn Smith was the executrix of the estate of Verna Mae Taylor Crosby.

St. Regis Paper Company ("St. Regis") issued the original promissory note on May 17, 1977, and the payments due under terms of the promissory note were paid to L.O. Crosby Jr. until his death in 1978. The decedent's will bequeathed a two-thirds interest in the promissory note to Mr. Crosby's wife, Verna Mae Crosby.

On May 17, 1981, two separate promissory notes were executed by St. Regis to the decedent's wife along with Ochsner Medical Foundation ("OMF"), which was the one-third beneficiary, in exchange for their respective interests in the original promissory note of $10.3 million.

Exhibit 1
The Estate of Meyer B. Berkman
Fair Market Value and Amount of Gift of the Promissory Notes

Promissory Note Issue Date	Note Face Amount	Fair Market Value	Amount of the Gift
November 15, 1968	$100,000	$ 85,000	$ 15,000
April 24, 1969	$ 50,000	$ 37,500	$ 12,500
November 19, 1970	$ 30,000	$ 24,000	$ 6,000
November 19, 1970	$ 40,000	$ 32,000	$ 8,000

Source: Bernat v. Commissioner, T.C. Memo. 1979-46.

Exhibit 2
The Estate of Meyer B. Berkman
Fair Market Value of the Promissory Notes for Estate Taxes

Promissory Note Issue Date	Note Face Amount	Fair Market Value
November 15, 1968	$100,000	$ 50,080
April 24, 1969	$ 50,000	$ 24,040
November 19, 1970	$ 30,000	$ 13,524
November 19, 1970	$ 40,000	$ 18,032
March 2, 1972	$ 55,000	$ 22,044

Source: Bernat v. Commissioner, T.C. Memo. 1979-46.

One of the promissory notes had a face amount of approximately $5.5 million, with yearly principal payments of approximately $343,733 payable to the decedent's wife. The yearly payments were scheduled to begin on May 17, 1982, and were scheduled to continue on the same day each year before concluding in 1997.

The remaining one-third interest (approximately $2.7 million) was given to OMF.

On January 31, 1985, St. Regis merged into Champion International Corporation ("Champion"). Champion was expected to pay the unpaid note balance of approximately $5.5 million to the decedent's wife.

Verna Mae Crosby passed away on April 28, 1988. At the time of Ms. Crosby's death, (1) the unpaid principal due under the note totaled $3.4 million and (2) the interest required to be paid over the remaining term of the note totaled $4.1 million.

In estimating the value of her promissory note, the taxpayer's valuation analyst applied a 10.09 percent effective interest rate of a publicly traded bond that Champion issued as a starting point.

The valuation analyst then added a series of adjustments to the starting point in order to compensate for the differences between the publicly traded debt of the issuer and the promissory note of the estate.

Exhibit 3 presents a series of adjustments that the valuation expert applied in the estimation of the value of the promissory note.

The adjustments were made based on the following characteristics of the Champion publicly traded debt instruments:

1. Well documented (i.e., prospectus supplement, financial statements, and legal opinions)
2. Tradeable in denominations as low as $1,000
3. Having significant legal protections in the event of default
4. Having restrictions on the business operations of Champion to provide further security

Exhibit 3
Smith v. United States
Adjustments to Required Yields

Base Yield	10.09%
Adjustments:	
Lack of Marketability	0.5%
Lack of Indenture or Covenant	1.0%
Lack of Formal Acknowledgement by the Borrower	1.0%
Subordination to All Better Documented Debt of the Borrower	1.0%
Uncertainty regarding the Legal Entity Bearing Liability	1.0%
Unusual Payment Schedule	0.5%
Lack of Divisibility	0.5%
Semiannual Payout Rate	15.6%
Convert to Annual Convention (note payments on annual basis)	16.2%
Required Yield Used	16.0%

Source: Smith v. United States, 923 F.Supp. 896 (S.D. Miss. 1996).

The taxpayer's valuation analyst testified in the U.S. District Court trial that the absence of these factors were important in determining potential buyers for the estate's promissory note.

The valuation analyst made an adjustment based on a lack of response from the issuer, Champion. When the taxpayer's valuation analyst tried to obtain adequate information for the valuation from Champion, he only received a one-page letter with incorrect information about the promissory note.

The valuation analyst surmised that a hypothetical purchaser would have similar issues securing information about the promissory note.

Finally, the U.S. District Court for the Southern District of Mississippi found the taxpayer expert's valuation of the promissory note to be reasonable.

The District Court concluded that the taxpayer analyst's valuation was consistent with the facts known and knowable at the time that the interest in the promissory note was determined and would have been available to a good faith purchaser at that time.

Estate of Hoffman v. Commissioner

The U.S. Tax Court decision in the *Estate of Hoffman v. Commissioner* concerned the valuation of two unsecured promissory notes issued from a family partnership held by Marcia P. Hoffman (the decedent) with a 20-year term.[19]

At the date of death, the decedent owned a 27.5 percent ownership interest in Clubside, a family partnership owned by the decedent and her family.

The Service and the estate disagreed on the fair market value of the promissory notes issued by Clubside.

One promissory note was payable to the decedent and the other note was payable to Hoffman Associates, Inc. At the time of Marcia Hoffman's death, the decedent owned all 7,500 shares of stock in Hoffman Associates.

The estate's valuation analyst estimated the fair market value of the Clubside promissory notes based on a required rate of return on similar market investments. The estate's valuation analyst relied on Moody's, Standard & Poor's, and Fitch ratings agencies to find comparable debt securities.

The estate's valuation analyst considered the lack of marketability discount because the Clubside notes lacked a public market for sale. Taking into account this lack of marketability, the estate's valuation analyst concluded an investor would require a rate of return of at least 25 percent higher than the 18 percent return offered by his comparable publicly traded bonds.

Therefore, the estate's valuation analyst determined the appropriate rate of return for the Clubside notes was 22.5 percent.

The Service's valuation analyst contended that the value of the promissory note was based on the payments and the rate of return that a holder of the notes would require.

To determine an appropriate rate of return, the Service's valuation analyst considered the following factors:

1. Interest rates of various debt securities
2. Corporate bonds of various ratings
3. Interest rates for 30-year conventional mortgages
4. Yields on U.S. Treasury securities
5. U.S. prime rate
6. Venture capital returns

The Service's valuation analyst concluded that the promissory notes did not have characteristics similar to highly speculative and default bonds. The Service's valuation analyst concluded 12.5 percent as the appropriate rate of return required for the promissory note inclusive of the lack of marketability of the promissory note.

The Tax Court ultimately concluded that:

1. a 12.5 percent rate was appropriate and
2. the Service's valuation analyst had correctly valued the promissory notes.

Promissory Note Valuation Methodology

In the above three judicial decisions, the courts considered the fair market value of a promissory note under Sections 20.2031-4 and 25.2512-8 of the Internal Revenue Code. The valuation analysts offered evidence to prove that the fair market value of a promissory note was lower than the sum of unpaid principal and accrued interest.

In *Bernat v. Commissioner,* the Tax Court determined the fair market value of the promissory notes, considering the following factors:

1. Interest rates available in the market as compared to the interest rate of the notes
2. The date of maturity
3. The lack of security
4. The solvency of the debtors

In *Estate of Hoffman v. Commissioner*, the Service's valuation analyst determined the fair market value of the notes based on a required rate of return and the timing of payments.

In estimating the value of promissory notes, both cases applied a required rate of return that a note holder would demand of an issuer, considering rates of return on similar investments available in the market as of the valuation date.

The required rate of return applicable to the notes is determined based on the risk inherent in the investment. In other words, an investor (or lender) would accept a rate of return no lower than that available from other investments with equivalent risk.[20]

When the rate of return on the note appropriately reflects the risk of the borrower, the fair market value of the note equals its principal amount (or its "face value").[21]

The value of a financial instrument generating future payments at a specific time is determined by its present value at the transaction date. To the lender, the fair market value of a promissory note equals the present value of future principal and interest payments discounted at a risk-adjusted rate of return to the valuation date.[22]

When the risk associated with the future payments of the note increases, the rate of return the lender requires will increases. And, accordingly, the present value of the note will decrease. The opposite result occurs when the risk and the required rate decrease.[23]

Accordingly, the required rate of return of a note reflects the risk associated with the future payments and determines the fair market value of the note.

For example, if a note secures collaterals, the required rate of return will be lower than that of an unsecured note.

In *Estate of Hoffman v. Commissioner*, to determine an appropriate required rate of return, the Service's valuation analyst considered rates of return available in the market, such as interest rates of debt securities, corporate bonds ratings, interest rates for conventional mortgages, U.S. Treasury

"[T]he proper way to value notes and mortgages is to consider all available financial data and all relevant factors affecting the fair market value."

securities yields, the U.S. prime rate, and venture capital returns.

Once an appropriate required rate of return is determined based on inherent risk in the note, a valuation analyst should carefully consider how to estimate the fair market value of the note discounted at such required rate of return to the valuation date.

One example is a promissory note required to pay periodic interest payments with the principal balance due at maturity (similar to an ordinary annuity).

The present (i.e., fair market) value of the periodic coupon payments and maturity value (or par value) is calculated using the Figure 1 formula according to the *Handbook of Fixed Income Securities.*[24]

Internal Revenue Service Technical Advice Memorandum 8229001

In *Smith v. United States,* in the calculation of an appropriate required yield, the taxpayer's valuation analyst applied adjustments to the publicly traded debt of the promissory note issuer, thereby increasing the required yield from approximately 10.1 percent to 16.0 percent. The increase in the required yield accounted for the specific risk of the promissory note compared to that of publicly traded debt in the market.

In addition, in *Bernat v. Commissioner*, the Tax Court considered the rate of interest available in the market (effectively the U.S. prime rate at the time), as well as the following factors:

1. The maturity date
2. The lack of security
3. The solvency of the debtors

The rationale for these adjustments is within the scope of TAM 8229001.[25]

TAM 8229001 defines the meaning of Revenue Ruling 67-276 in determining the value of a mortgage owned by a decedent at the day of death.[26]

According to TAM 8229001, although a sentence of the Revenue Ruling indicates a secured mortgage must be valued at face value,[27] the meaning of the Revenue Ruling is that "the proper way to value notes and mortgages is to consider all available financial data and all relevant factors affecting the fair market value."[28]

To describe what kind of financial data and relevant factors an analyst should consider in estimating the fair market value of a promissory note, the following list of factors provides a summary of TAM 8229001. These factors are also illustrated in the previously mentioned judicial decisions.

Presence or Lack of Promissory Note Covenants

Covenants are set forth within an indenture, or a formal debt agreement. Covenants confirm whether certain activities will (affirmative covenants) or will not (negative covenants) be carried out.

Covenants include, but are not limited to, working capital requirements, interest coverage ratios, prepayment penalties, debt/equity ratios, and dividend payments. Such covenants are intended to protect the interests of the lender.

Therefore, covenants tend to reduce lender risk and often result in a lower required yield.

The Solvency of the Borrower

With regard to the *Bernat v. Commissioner* decision, the Tax Court considered the borrowers' solvency as one of relevant factors in estimating the fair market value of the promissory notes.

Figure 1
Illustrative Promissory Note Valuation Formula

$$PV = \frac{c}{(1+i)^1} + \frac{c}{(1+i)^2} + \frac{c}{(1+i)^3} + \ldots \frac{c}{(1+i)^n} + \frac{M}{(1+i)^n}$$

$$PV = c \left[\frac{1 - \left[\frac{1}{(1+i)^n} \right]}{i} \right] + \frac{M}{(1+i)^n}$$

Where:
PV = Present Value of a Promissory Note
c = Periodic Interest Payment ($)
n = Number of Periods
i = Required Yield
M = Maturity Value (or face value)

Strong debt solvency and repayment ability of the borrower will result in lower risk for the lender and a lower required rate of return.

Value of the Security

Both Revenue Ruling 67-276 and TAM 8229001 indicate the value of the security as an important factor in estimating the value of the promissory note. "Security" here specifies collateral or the pledged security of the borrower. The higher the security value, the lower the risk of the lender, and the lower the required rate of return.

Term of the Note

All debt holders confront interest rate risk, which is the risk that a note's investment value would change given a fluctuation in interest rates. Such investors also confront reinvestment risk if they are unable to reinvest proceeds from the existing note at the same interest rate as the current rate of return.

The longer the duration of the note, the higher the interest rate risk and reinvestment risk, and the higher the required rate of return.

Comparable Market Yield

In *Estate of Hoffman v. Commissioner*, in his determination of an appropriate required rate of return, the Service's valuation analyst considered market yields such as interest rates of debt securities, corporate bond rates, mortgage rates, U.S. Treasury securities rates, the U.S. prime rate, and venture capital returns.

A comprehensive valuation analysis typically considers a wide range of financial instruments with different risk and return characteristics.

Payment History of the Borrower

Payment history of the borrower is important to measure the risk of the borrower. If payments are current and have been made in a timely manner, the risk associated with the promissory note decreases and, therefore, the required rate of return decreases.

Size of the Note

To calculate the required yield to discount the promissory note, the plaintiff's valuation analyst in the *Smith v. United States* decision compared the promissory note to the publicly traded debt of the issuer (or lender).

One of the differences between the promissory note and the publicly traded debt is that the publicly traded debt was tradeable in denominations as low as $1,000.

Potential buyers of the note will be limited because buying the note requires sizable money to invest. Accordingly, the larger the size of the note, the higher the required rate of return.[29]

In addition, TAM 8229001 states that the effect of Section 20.2031-4 is to recognize "(1) that any principal amount payable in the future normally carries an interest accrual with it and (2) that when the stated interest rate on the obligation is fair (equal to the current market rate of interest for such type of obligation), the total present value of all payments of principal and interest will equal the principal amount of the obligation."

The TAM also indicates that the present value of such payments is less if the stated rate of interest on the note is less than the current market rate of interest.

In summary, under TAM 8229001, the Service indicated that "all available data and all relevant factors affecting the fair market value must be considered,"[30] in determining the value of a promissory note.

Face value plus accrued interest[31] is not necessarily the value to be included in the gross estate or taxable gift. A promissory note can be valued at less than face value plus accrued interest if the donor or estate demonstrates by satisfactory evidence that the value is lower.[32]

Summary and Conclusion

Valuation analysts are often engaged to estimate the fair market value of a promissory note for transfer tax compliance purposes.

The fair market value of a promissory note is the sum of the unpaid principal and accrued interest to the date of gift or death under Regulations Sections 25.2512-4 and 20.2031-4.

However, these regulations also indicate that the taxpayer may rebuke this value by presenting compelling evidence that the promissory note is worth less than the sum of the unpaid principal and accrued interest.

This discussion presented note valuation methodologies and various factors that the analyst may consider in estimating the fair market value of a promissory note. It also summarized several relevant judicial decisions and valuation professional literature.

This discussion especially clarifies the meaning of TAM 8229001 and its application in estimating the fair market value of promissory notes.

In conclusion, in estimating the fair market value of a promissory note, the analyst may carefully consider the following factors:

1. Whether the note represents a bona fide transaction for adequate and full consideration
2. Whether the required yield reflects the inherent risk of the note and its issuer (borrower), considering various factors that this discussion suggests

Accordingly, the valuation analyst may estimate the fair market value of the promissory note future cash flow by discounting the note based on an appropriate required yield rate.

Notes:

1. Internal Revenue Service Technical Advice Memorandum 8229001 (February 1, 1982)
2. Treasury Regulations §25.2512-8; 25.2511-1(g)(1).
3. Estate of Lockett v. Commissioner, T.C. Memo 2012-123 (Apr. 25, 2012) at 21 (citing Van Anda v. Commissioner, 12 T.C. 1158, 1162 (1949)).
4. Estate of Lockett v. Commissioner at 22-23, 25-27.
5. Miller v. Commissioner, T.C. Memo. 1996-3 (Jan. 11, 1996).
6. Ibid.
7. Ibid.
8. Treasury Regulations § 25.2512-4, §20.2031-4.
9. Estate of Hoffman v. Commissioner, T.C. Memo. 2001-109 (May 9, 2001).
10. Revenue Ruling 67-276, 1967-2 C.B. 321.
11. Bernat v. Commissioner, T.C. Memo. 1979-46 (Jan. 31, 1979).
12. Treasury Regulation. § 25.2512-8.
13. Internal Revenue Code § 2512 (a), (b).
14. Internal Revenue Code § 2031.
15. Internal Revenue Code § 2035.
16. Internal Revenue Code § 2035(d).
17. Smith v. United States, 923 F.Supp. 896 (S.D. Miss. 1996).
18. Id.
19. Estate of Hoffman v. Commissioner, T.C. Memo. 2001-109.
20. Aaron M. Stumpf and Jesse A. Ultz, "Intra-Family Loan Valuation Issues," Stout Risius Ross newsletter (Spring 2010).
21. Robert Schweihs, "AFR and the Value of Debt," Willamette Management Associates *Insights* (Summer 2012).
22. Ibid.
23. Frank J. Fabozzi and T. Dessa Fabozzi, *Handbook of Fixed Income Securities*, 4th ed. (Chicago: Richard D. Irwin, 1995), 55.
24. Ibid.
25. Internal Revenue Service Technical Advice Memorandum 8229001.
26. Revenue Ruling 67-276, 1967-2 C.B. 321
27. Ibid.
28. Ibid.
29. Treasury Regulation §20.2031-4.
30. Ibid.
31. Ibid., Treasury Regulation § 25.2512-4, §20.2031-4.
32. Internal Revenue Service Technical Advice Memorandum 8229001.

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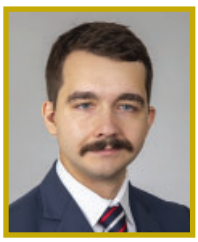

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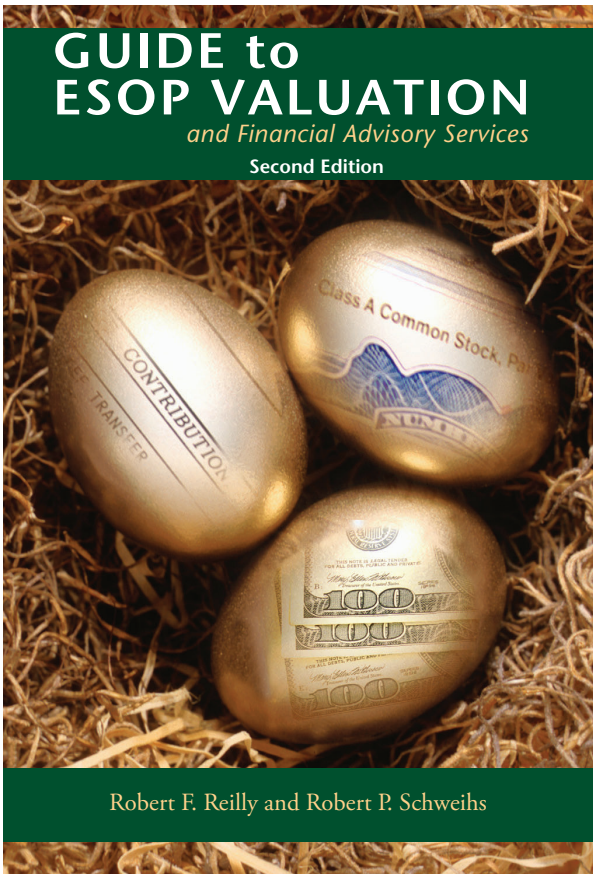

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Valuation Considerations for Preferred Equity Interests

Ben R. Duffy and Aiden B. Gonen

The valuation of preferred equity interests is often influenced by the market-based yields for comparable publicly traded securities. The yields of publicly traded preferred equity securities are typically correlated with corporate bond yields. Therefore, rising interest rates may create opportunities to transfer preferred equity interests at a valuation discount (compared to the stock's par or stated value). This discussion presents (1) Internal Revenue Code professional guidance with respect to the valuation of preferred equity interests, (2) a summary of the generally accepted procedures for developing the valuation of preferred equity interests, and (3) an illustrative example of a preferred equity interest valuation with consideration to the impact of rising interest rates.

Introduction

Estate planners sometimes recommend the recapitalization of their clients' privately owned company stock into preferred equity interests and common equity interests. Such a recapitalization may allow the preferred equity holder to receive a predictable stream of income while allowing the common equity holder to benefit from the appreciation of the privately owned company.

Since the enactment of Internal Revenue Code Sections 2701 and 2704, such common stock to preferred stock recapitalizations have become less popular. However, there are instances when a privately owned company recapitalization may still be a consideration for estate planning.

This discussion does not provide legal advice or estate planning advice. Rather, the purpose this discussion is to provide an overview of preferred stock from a valuation perspective.

Valuation analysts regularly develop fair market value valuations of preferred stock for gift or estate tax planning and compliance purposes. Additionally, valuation analysts are often engaged to determine a reasonable market yield range for a contemplated recapitalization.

In order to develop a credible valuation analysis of preferred equity, an analyst may consider numerous factors, including the following:

1. The rights and preferences of the subject equity interest
2. Revenue Ruling 83-120 guidance
3. The generally accepted valuation methods applied in the equity security valuation analysis

Characteristics of Preferred Stock

Preferred stock (also referred to herein as preferred shares or preferred equity) is a class of equity ownership that is senior to common stock. Preferred stock is a type of hybrid security that consists of elements of both equity and debt.

Similar to a bond, the holder of preferred stock is promised a fixed stream of income, in the form of

dividends, each year. Unlike most bonds, with maturity at some point in time from inception, preferred stock is typically perpetual.

Preferred stock is typically similar to bonds in that preferred shares are not always given voting power over a company's management actions.

However, preferred stock is a class of equity ownership, and it is at the company's discretion to make preferred share dividend distributions each year. Dissimilar to interest payments promised in debt instruments, preferred dividends are not guaranteed.

In addition, preferred equity is subject to different risks and liquidation preferences relative to the interest payments promised in debt instruments.

In addition to the above-mentioned rights, there are several possible additional features or attributes that can, individually or in combination, be attached to preferred equity stock/unit issuance in order to enhance the value of the said preferred equity stock or unit.

Possible additional preferred stock features include, but are not limited to, the following:

1. Redeemable (callable) at the option of the issuer
2. Cumulative distributions (i.e., required distributions made by the company to its preferred stakeholders)
3. Voting rights, which could be shared pro rata with, or superior to, the common equity, or be fractional
4. The right to vote on a "special resolution" to affect a fundamental corporate change
5. Sinking fund requirements (i.e., money set aside or saved by the issuing company) providing for the redemption of the preferred equity by the issuer
6. Convertibility (i.e., the holder's right to convert the preferred equity shares/units into common or participating shares/units, or into another class), usually exercisable during a specified period of time
7. Option or warrant attached, entitling the holder to purchase common stock at prices, in amounts, and during periods, stipulated (e.g., an option—much like a demand note—for the preferred equity investor to demand a redemption or repurchase of the preferred equity stock)
8. Restriction rights (e.g., restricted from public listing or public selling)
9. Participation rights (e.g., once the basic, fixed dividend is paid, the preferred equity stock may share in further distributions along with the common stock)
10. Exchanging rights (either into bonds of the issuer or into common stock of an affiliated entity)
11. Seniority rights (i.e., a provision making the particular class of stock senior to all other preferred classes)
12. The dividend, rather than being fixed, may be a function of the bank prime rate of interest (for example, adjustable rate or variable rate preferred equity stock)
13. There may be a premium paid on the preferred equity shares/units upon a dissolution of the company

As discussed below, the rights of a specific preferred stock interest may have valuation implications. Revenue Ruling 83-120 provides professional guidance to both taxpayers and valuation analysts related to the valuation of preferred interests.

Revenue Ruling 83-120

In valuing the stock of a closely held corporation for estate and gift tax purposes, the valuation analyst typically considers the guidance provided by Revenue Ruling 59-60. Revenue Ruling 59-60 provides guidance related to the general approaches, methods, and factors to be considered in valuing shares of capital stock.

However, Revenue Ruling 59-60 does not provide specific guidance for the valuation of preferred stock or units. Revenue Ruling 83-120 was promulgated for the purpose of providing additional factors to be considered in valuing the preferred stock of a closely held business.

Preferred Stock Considerations

According to Revenue Ruling 83-120, in general, the important factors to be considered in developing the valuation of preferred stock include the following:

1. Dividend yield
2. Dividend coverage
3. Protection of its liquidation preference

The following discussion provides a summary of each factor, as described in Revenue Ruling 83-120:

- Dividend Yield – Whether the yield of the preferred stock supports a valuation of the stock at par value depends in part on the adequacy of the dividend rate.

  The adequacy of the dividend rate should be determined by comparing its dividend rate with the dividend rate of high-grade publicly traded preferred stock.

  A yield lower than that of high-grade preferred stock indicates a preferred stock value of less than par. If the rate of interest charged by independent creditors to the corporation on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred stock should be correspondingly higher than the yield on high quality preferred stock.

  Ideally, publicly traded preferred stock for companies having a similar business and similar assets with similar liquidation preferences and terms would be identified in order to determine a yield required in arm's-length transactions for closely held preferred stock.

  However, such comparable securities frequently do not exist. Therefore, the guideline publicly traded securities may be selected for comparison with appropriate adjustments made for differing factors.

- Dividend Coverage – The actual dividend rate on a preferred stock can be assumed to be its stated rate if the issuing corporation will be able to pay its stated dividends in a timely manner and will, in fact, pay such dividends.

  The risk that the corporation may be unable to timely pay the stated dividends on the preferred stock can be measured by the coverage of such stated dividends by the corporation's earnings.

  Coverage of the dividends is typically measured by the ratio of:

  1. The sum of pretax and pre-interest earnings to
  2. The sum of the total interest to be paid and the pretax earnings needed to pay the post-tax dividends

  Inadequate coverage exists where a decline in corporate profits would be likely to jeopardize the corporation's ability to pay dividends on the preferred stock. The ratio for the preferred stock in question should be compared with the ratios for high quality preferred stock to determine whether the preferred stock has adequate coverage.

  Prior and prospective earnings history may be important in this determination. Inadequate coverage may indicate that the value of preferred stock is lower than its par value. Moreover, the absence of a provision that preferred dividends are cumulative raises questions concerning whether the stated dividend rate will, in fact, be paid.

  Preferred stock with noncumulative dividend features will normally have a value substantially lower than a cumulative preferred stock with the same characteristics.

- Protection of Liquidation Preference – Whether the issuing corporation will be able to pay the full liquidation preference of the preferred stock at the date of liquidation should be taken into account in determining fair market value.

  This risk can be measured by the protection afforded by the corporation's net assets (or equity). Such protection can be measured by the ratio of the excess of the market value of the company's assets, divided by its liabilities to the aggregate liquidation preference.

  The protection ratio may be compared with the ratios for high quality preferred stock. This comparison may consider the adequacy of coverage.

  Inadequate asset protection exists where any unforeseen business events would be likely to jeopardize the corporation's ability to pay the full liquidation preference to the holders of the preferred stock.

Additionally, Revenue Ruling 83-120 states that the following factors should be considered in the valuation of preferred interests:

- Voting Rights – Another factor to be considered is whether the preferred stock has voting rights and, if so, whether the preferred stock has voting control.
- Covenants – Peculiar covenants or provisions of the preferred stock of a type not ordinarily found in publicly traded preferred stock should be carefully evaluated to determine the effects of such covenants on the value of the preferred stock.

In general, if covenants would inhibit the marketability of the stock or the power of the holder to enforce dividend or liquidation rights, such provisions may reduce the value of the preferred stock by comparison to the value of preferred stock not containing such covenants or provisions.

- Redemption Privilege – Whether the preferred stock contains a redemption privilege is another factor to be considered in developing the value of preferred stock.

  The value of a redemption privilege triggered by death of the preferred shareholder may not exceed the present value of the redemption premium payable at the preferred shareholder's death (i.e., the present value of the excess of the redemption price divided by the fair market value of the preferred stock upon its issuance).

  The value of the redemption privilege may be reduced to reflect any risk that the corporation may not possess the sufficient cash needed to redeem its preferred stock at the stated redemption price.

Revenue Ruling 83-120 also provides guidance related to the effects of the preferred stock on common stock valuation.

Common Stock Considerations

Revenue Ruling 83-120 summarizes the following considerations with rest to common stock valuation:

- Preferred Stock Participation – If the preferred stock has a fixed dividend rate and is nonparticipating, the common stock has the exclusive right to the benefits of future appreciation of the value of the corporation.

  This right is valuable and usually warrants a determination that the common stock has substantial value. The actual value of this right may depend on the corporation's past growth experience, the economic condition of the industry in which the corporation operates, and general economic conditions.

  The factor to be used in capitalizing the corporation's prospective earnings may be determined after an analysis of numerous factors concerning the corporation and economy as a whole (see Revenue Ruling 59-60).

- Voting Rights – A factor to be considered in determining the value of the common stock is whether the preferred stock has voting rights.

  Voting rights of the preferred stock, especially if the preferred stock has voting control, could under certain circumstances increase the value of the preferred stock and reduce the value of the common stock.

  This factor may be reduced in significance where the rights of common stockholders as a class are protected under state law from actions by another class of shareholders, particularly where the common shareholders, as a class, are given the power to disapprove a proposal to allow preferred stock to be converted into common stock.

The issue of preferred stock participation can have material impacts on a common stock valuation analysis. Cash flow that would otherwise be distributed to the common stockholders may be absorbed by the preferred stockholders.

This factor may have liquidity implications for common stockholders and may be considered by the analyst when determining applicable valuation adjustments for lack of marketability.

An analyst should not ignore preferred equity capital when discounting future cash flow. The typical present value discount rate to apply to net cash flow to invested capital is a company's weighted average cost of capital ("WACC").

The WACC represents the weighted average cost of each of the components in a company's actual capital structure (i.e., debt, common shareholders' equity, and preferred shareholders' equity capital).

The basic formula for computing a company's after-tax WACC is presented as follows:

$$\text{WACC} = (K_e \times W_e) + (K_p \times W_p) + (K_d[1—t] \times W_d)$$

where:

K_e	=	Company's cost of equity capital
K_p	=	Company's cost of preferred equity capital
K_d	=	Company's cost of debt capital
W_e	=	Percentage of equity capital in the capital structure
W_p	=	Percentage of preferred equity capital in the capital structure
W_d	=	Percentage of debt capital in the capital structure
t	=	Company's effective corporate income tax rate

When developing a business valuation, an analyst may consider a company's (1) cost of preferred equity capital and (2) percentage of preferred equity in the total capital structure.

Preferred Equity Analysis

The following provides general guidance for valuing preferred equity interests while applying the considerations of Revenue Ruling 83-120. Every valuation is unique and the specific factors applicable to the subject interest should be considered when determining the appropriate methodology for valuing a preferred equity interest.

The following discussion is intended to provide a general (but not necessarily complete) process for analyzing a preferred equity interest.

In estimating the fair market value of a preferred equity, the analyst may consider the following:

1. The rights and preferences of the subject interest
2. The above-mentioned guidance provided by Revenue Ruling 83-120
3. The generally accepted valuation methods applied in equity security valuation analysis

One simple valuation formula for preferred equity stock/unit is expressed as follows:

$$\frac{\textit{Annual Dividend Payments}}{\textit{Required Rate of Return}}$$

This is an example of the dividend discount method ("DDM") applicable for perpetual cash flow.

The DDM considers the cash flow (annual dividend payments) distributed to the investor of the preferred equity stock/unit.

The discount rate (required rate of return) applied in the DDM is a function of market rates of interest. It also contains a risk component arising from the inability to accurately predict future cash flow. The risk may result from such fundamentals as the company's underlying financial condition and earning power.

Consequently, the DDM method is to estimate a market value of the preferred equity stock/unit by applying a required rate of return to the annual dividend payments.

If the preferred equity stock/unit is redeemable and not convertible, its value may be expressed as follows:

$$\sum_{t=1}^{n} \frac{C_t}{(1+k)^t}$$

where:

C_t = Cash flow (including redemption price and dividends) generated in the future period

t = Period when cash flow is generated

k = Required rate of return at which cash flow is to be discounted back to the present

n = Number of periods until redemption

The required rate of return applied to discount the expected cash flow is based on an assessment of the risk through two specific components:

1. Issue-specific risk (i.e., risk inherent in the particular class of preferred equity stock/unit being valued, in particular the specific attributes and characteristics of the stock/unit)
2. Company-specific risk (i.e., risk relating to the issuer itself)

Whether the market required rate of return (usually expressed as a yield on the preferred equity stock/unit) supports a valuation of the preferred

equity stock/unit at its stated face value partly depends on the adequacy of the dividend rate.

Required Market Rate of Return

The required rate of return is determined by comparing the subject dividend rate with that of a high grade, publicly traded guideline preferred equity stock/unit.

If the interest rate charged by arm's-length lenders on the corporation's debt is higher than the rate charged by most creditworthy borrowers (e.g., AAA-rated borrowers), then the required rate of return on the preferred equity stock/unit should correspondingly be higher than the required rate of return on a high quality guideline preferred equity stock/unit.

As stated in Revenue Ruling 83-120, such comparables frequently do not exist. Therefore, the guideline publicly traded securities may be selected for comparison with appropriate adjustments made for differing factors.

In some instances, corporate bonds may be the best guideline publicly traded securities. However, it is important to consider the specific rights and features of the subject preferred equity stock/unit.

Unlike most bonds, with maturity at some point in time from inception, preferred stock is typically perpetual. Due to this, long-dated corporate bonds may be more applicable than short-dated corporate bonds.

All else equal, long-dated corporate bonds typically offer a higher interest rate than short-dated corporate bonds. This higher interest rate is attributable to the additional interest rate volatility exposure that a long-dated bond holder is subject to.

The impact of increasing interest rates is illustrated later in this discussion.

Lack of Marketability Considerations

An adjustment to the required market rate of return may be applicable depending on the specific rights and preferences of the preferred stock/unit.

Preferred equity stocks/units may be subject to an adjustment for lack of marketability if:

1. there is no retraction feature;
2. the holder of the preferred equity stock/unit does not control the subject company;

3. there is no "put" provision for the preferred equity stock/unit in the partners' buy/sell agreement (if any); or
4. there are restrictions on transferability, pursuant to corporate law and/or agreement among the company's partners.

Even if the preferred equity stock/unit is retractable, such feature provides liquidity only if the issuer has the financial capacity to redeem the preferred equity stock/unit when the investor makes such a request.

In estimating the fair market value of a preferred equity interest, the analyst may consider the expected dividend coverage and expected liquidation coverage of the subject interest, as well as other financial coverage and liquidity metrics.

The dividend coverage ratio is typically calculated as follows:

$$\frac{\textit{Net Income}}{\textit{Required Preferred Dividend Payout Amount}}$$

A preferred dividend coverage ratio below one indicates that a company will not be able to cover its annual preferred dividend payout amount. As a company offers additional preferred stock, the net income required to meet the preferred dividend payout amount increases.

When analyzing preferred stock, it may be important to consider the prospective net income of the issuing company. Although a company may

be able to fulfill its preferred dividend payouts now, does not mean the company may be able to fulfill its preferred dividend payouts into perpetuity.

The analyst typically considers the long-term net income expectations of the issuing company.

Impact of Rising Interest Rates

Although preferred stock is not a debt security, interest rates are typically correlated with the required rate of return of preferred stock. The general theory is that preferred stockholders have less of a claim in bankruptcy and, therefore, preferred stock yields are typically higher than more senior debt instruments.

Preferred stock can be viewed as a premium spread over its debt counterparties. A holder of preferred stock is less likely to receive bankruptcy proceedings relative to holders of debt and, therefore, the risk is usually captured in a premium over debt yields in the same company.

Interest rate risk is often present in preferred stock because higher interest payments can:

1. reduce a company's willingness to make optional dividend payments or
2. push a company into bankruptcy because of an inability to make interest payments.

Valuation Example

The following simplified example illustrates:

1. the valuation of a hypothetical preferred equity unit and
2. the potential valuation implications of increasing interest rates.

As of June 1, 2021, an investor John P. Investor considers an investment in a private business called XYZ Company. John P. Investor desires a fixed payment and perpetual investment opportunity in XYZ Company.

Fortunately for John P. Investor, XYZ Company is offering one share of preferred stock with a $100 par value and a fixed stated dividend yield of 5 percent.

John P. Investor calculates the value of the preferred stock using the previously described DDM:

$$Value\ of\ XYZ\ Company\ Preferred\ Stock = \frac{\$5\ per\ share}{Required\ rate\ of\ return\ (required\ dividend\ yield)}$$

One component of John P. Investor's analysis is determining the required rate of return, or yield, to use in discounting the future dividend stream to a present value.

Exhibit 1 represents the impact of the stated dividend yield and required rate of return on the price of preferred stock relative to par value.

The required rate of return is often established by reviewing market rates of return of other similar, but publicly traded, preferred stock securities. The availability of publicly available preferred stock data is often limited.

An alternative to searching for publicly traded preferred stock data is observing corporate bonds of companies comparable to the Subject Company issuing the preferred stock (in this case, XYZ Company).[1]

In order to determine which public company corporate bond yield is the most applicable to the preferred stock of XYZ Company, John P. Investor first assesses the credit quality of the subject preferred interest.

While the subject preferred interest may not be rated by a credit rating agency, the analyst can develop a synthetic credit rating for the equity interest by analyzing certain coverage ratios related to dividends and liquidation.

After an analysis of XYZ Company, John P. Investor identifies that the financial ratios of XYZ Company are most comparable to high quality, AAA-rated companies.

Subsequently, John P. Investor selects publicly traded corporate bonds—that have similar business operations, features, and credit quality as the subject preferred interest.

John P. Investor analyzes the publicly traded corporate bond yields and selects a market yield to maturity, or required rate of return, of 4 percent.[2]

Exhibit 1
Impact on Preferred Stock Value of Dividend Yield and Required Rate of Return

Characteristic	Price of Preferred Stock Relative to Par Value
Stated Dividend Yield > Required Rate of Return	Premium Price Relative to Par Value
Stated Dividend Yield = Required Rate of Return	Price Equal to Par Value
Stated Dividend Yield < Required Rate of Return	Discount Price Relative to Par Value

John P. Investor then reviews the specific rights and features of the preferred interest, in order to determine if a discount or premium should be applied relative to the comparable market yield.

As presented in Exhibit 2, John P. Investor identifies the rights and features of the preferred interest issued by XYZ Company and its effects on an investor's required rate of return.

In this case, John P. Investor identifies an additional risk premium adjustment relative to the subject preferred stock stated dividend yield of 4 percent. Therefore, the required rate of return of the preferred stock held by John P. Investor is 5 percent.

The formula for the value of the preferred stock is presented as follows:

$$Value\ of\ Preferred\ Stock = \frac{\$5}{5\%}$$

$$Value\ of\ Preferred\ Stock = \$100$$

Exhibit 2
John P. Investor Illustrative Example
Analysis of Hypothetical Preferred Stock

Characteristic of XYZ Company Preferred Stock	Effect on the Yield (Risk) of the Preferred Interest
Nonconvertible	Increases required rate of return
Cumulative	Decreases required rate of return
Fixed Dividend Rate	Depends on the market rate of return [a]
Liquidation Preference	Increases required rate of return
Nonparticipating	Increases required rate of return
No Put Option	Increases required rate of return
Nonredeemable	Decreases required rate of return
Nonvoting	Increases required rate of return

[a] Typically, if the market rate of return is greater than the fixed dividend rate, then the required rate of return increases. Likewise, if the market rate of return is less than the fixed dividend rate, then the required rate of return decreases.

As presented above, the value of the preferred stock in this example is equal to the par value of $100 per preferred stock share.

Current Interest Rate Environment

Continuing from the previous example of the preferred stock interest held by John P. Investor, we will look at a hypothetical valuation of the same preferred stock interest, assuming it is observed in a rising interest rate environment.

Although interest rates are currently below long-term historical levels, interest rates have increased during the short term.

Figure 1 presents investment-grade, high-quality market corporate bond spot rate data compiled by the Federal Reserve Economic Data ("FRED") from December 1, 2020, through June 1, 2022.

Let's assume that John P. Investor decides to sell his preferred stock interest in XYZ Company. Since XYZ Company stock is privately traded, John P. Investor performs the same preferred stock analysis as before in order to determine the potential gain (or loss) on his investment.

John P. Investor selects publicly traded corporate bonds—that have similar business operations, features, and credit quality as the subject preferred interest. John P. Investor realizes current broad market interest rates increased over the year leading up to June 2022.

John P. Investor also notices the yield to maturity on comparable companies that were AAA rated with similar rights and provisions is approximately 6 percent. Therefore, John P. Investor determines the new required market rate of return is approximately 5 percent, representing a 1 percent increase from June 2021.

John P. Investor also determines the same 1 percent risk premium adjustment to be applicable. Therefore, John P. Investor determines the applicable preferred rate of return for XYZ Company stock is 6 percent as of June 2022.

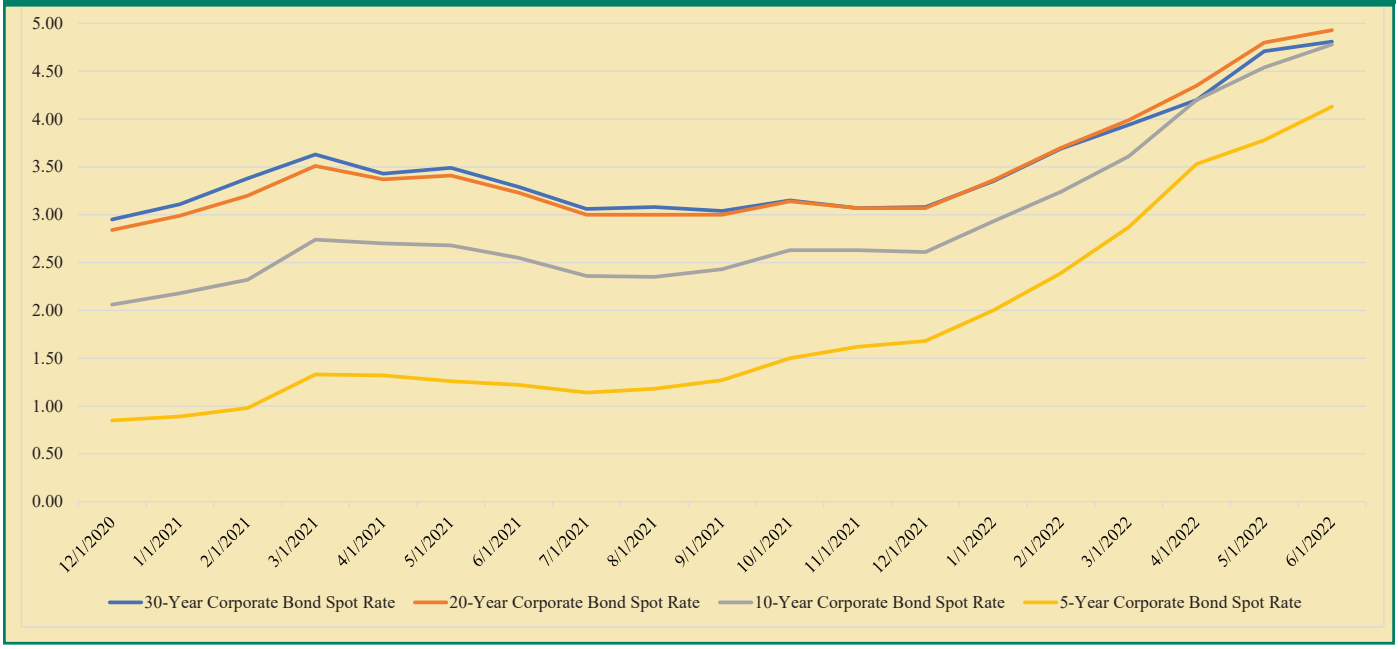
Presented below is the implied valuation of the XYZ Company preferred stock as of June 2022:

$$Preferred\ Stock\ Value = \frac{\$5}{6\ percent\ (the\ required\ rate\ of\ return\ determined\ by\ the\ investor)}$$

$$Value\ of\ Preferred\ Stock = \$83$$

Based on this simplified example, a 1 percent increase in the market required rate of return caused a $17 (or 17 percent) valuation discount relative to the June 2021 value of $100 per share.

Figure 1
Investment-Grade, High-Quality Market Corporate Bond Spot Rate - FRED Data



This valuation example illustrates the impact of broader interest rates on preferred stock.

The analyst valuing a preferred stock may consider (1) the security's rights and features, (2) an analysis of similar companies to the company issuing preferred stock (including similar credit ratings and business operations), and (3) an analysis of the comparable publicly traded preferred stock yields.

Summary and Conclusion

Valuation analysts are often engaged to:

1. provide financial consulting services related to the issuance of preferred equity and
2. develop the fair market value valuation of transferred preferred equity interests.

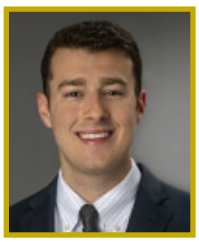
In the valuation of preferred equity interests for gift or estate tax purposes, the analyst may consider (1) the rights and preferences of the subject interest, (2) the guidance provided in Revenue Ruling 59-60, (3) the guidance provided in Revenue Ruling 83-120, and (4) the generally accepted valuation methods applied in equity security valuation analysis.

One component of any preferred stock analysis is determining the applicable required rate of return for the subject preferred equity interest. Often, comparable publicly traded securities do not exist, and the analyst may apply best judgement and expertise in order to determine the most applicable market rate of return.

The analyst may apply judgment when selecting a discount or premium to apply to the market rate of return. This process requires an understanding of the rights and privileges of the subject preferred equity, as well as an understanding of the risks associated with the subject company.

Notes:

1. Corporate bond yields may be dissimilar to preferred stock yields due to factors such as (1) seniority to preferred stock in the event of bankruptcy or sale of the company and (2) interest payments are legally required to be paid, rather than dividends, which may or may not be agreed by a company's board of directors. For these reasons, preferred stock typically implies a higher yield than its corporate bond counterpart.
2. The yield to maturity is the rate investors will earn when holding a bond until it reaches maturity. The yield to maturity represents the required rate of return of an investment.



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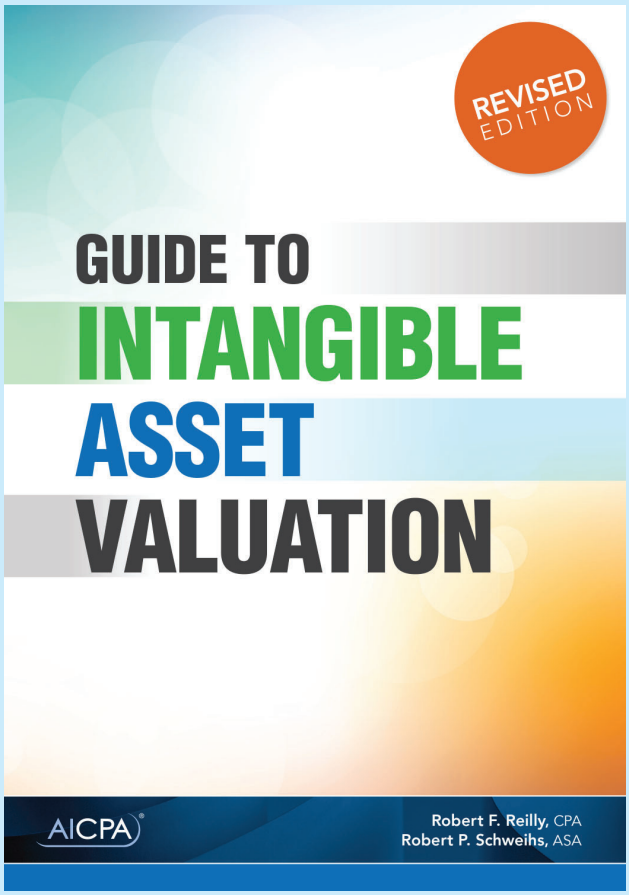
Guide to Intangible Asset Valuation

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
- Commercial bankers and investment bankers
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Guide to Intangible Asset Valuation

Table of Contents

Thought Leadership Discussion

Climate Change and Business Valuation

Barry W. Purnell

Following the departure of three ExxonMobil board members in an environmental, social, and governance ("ESG") proxy fight, interest has increased in ESG procedures and processes, for both defensive and offensive board applications. ESG business valuation considerations can vary based on numerous factors. Adding to these differences are regional governmental policies. Europe has taken a firm stance in applying a more rigorous ESG framework, and it is a major force in industry rules creation. Each year, governing ESG authoritative entities, from across the world, along with their procedural frameworks, continue to coalesce in their processes. One framework is available for the valuation analyst's consideration. This framework is incorporated in the Essential Guide to Valuations and Climate Change, *produced by the Chartered Professional Accountants of Canada. This discussion looks at this Canadian framework and also considers other frameworks.*

Engine No. 1

In May of last year, a small startup hedge fund ("Engine No. 1"), launched with just $250 million in assets, succeeded in replacing three members on ExxonMobil's board of directors. At the time, ExxonMobil had a market value of about $265 billion.

Engine No. 1 gathered some of the most powerful institutional investors and public pension funds to its cause, with a dissident message, asking for increased climate change spending and initiatives. Engine No. 1 invested $12.5 million in their proxy effort, while ExxonMobil spent over $100 million defending against it.

Given the ExxonMobil proxy loss, clearly there was a shareholder audience for the insurgent climate change message. This upset reflects increasing shareholder engagement and social activism, by those looking to change the landscape of corporate governance to something much greener.[1,2]

Engine No. 1 has flourished from an increased investor interest in environmental, social, and governance ("ESG") mandates and initiatives, and the ever-growing money flow drawn to those causes.

The Engine No. 1 analysis models use a research-based approach integrating nonmaterial but financially material ESG data, methods, and systems into traditional analysis. The requirements are that data be objective, replicable, and auditable.

The framework model structure is based on a scenario, with analysis applied to areas believed relevant, and meeting the above reporting constraints. Using independent sources, as well as estimates, they assess firm-level costs of emissions, waste, resource use, as well as other ESG factors.

Though proprietary, the Engine No. 1 analysis model is drawn from years of ESG study, analysis, and governance.[3]

The ESG Sovereigns

An abundance of ESG advising and governing bodies exist today. But what is changing is a growing consensus and consolidation in these governing bodies.

Larger, more established oversight groups are taking the reins in constructing the ESG analysis models of the future and in their future governance.

One of the major organizations involved in consolidation and uniform standards development is the United Nations Environment Program Finance Initiative ("UNEP FI"). UNEP FI developed a series

of working papers which outline methodologies for analysis and reporting.

Goldman Sachs has created a business unit purposed to study and advise on ESG issues, as they apply to investment decisions, called the GS Sustain Program.

The Chartered Professional Accountants of Canada have created a concise handbook for ESG analysis and reporting, the *Essential Guide to Valuations and Climate Change,* referred to going forward as "A4S." The Society of Chartered Financial Analysts has developed white papers, as has the Financial Accounting Standards Board.

But what is changing is the cooperation between these entities. Recently, the International Financial Reporting Standards Board began working jointly with the Financial Accounting Standards Board on a set of ESG analysis and reporting standards.[4]

A4S is a publication produced in association with the Chartered Professional Accountants of Canada and is the product of both business valuation professionals and industry participants.

Comparing the A4S model to other frameworks, the A4S framework proves to be both adaptable and well featured. It includes Excel tools supporting risk and opportunity identification, a scorecard, discounted cash flow integration, and market valuation, as well as adjustments guidance.

None of the reviewed ESG frameworks offer a one-size-fits-all formula that addresses climate change. Climate risks and opportunities vary significantly by region, asset class, and governance.

All the frameworks reviewed recommend that ESG data be captured based primarily on relevance and on a unique per-case basis. The general outline for analysis is relatively consistent across frameworks.

The number of ESG reporting agencies is considerable, with a depth of scientific expertise and information, allowing practitioners to both find and validate data.

Some of the main sources of ESG reported data and guidance are as follows:

- Sustainability Accounting Standards Board – The intended goal is the development of industry-specific ESG standards.
- CDP Disclosure Insight Action – This organization draws information from the largest organizations worldwide for detailed information on climate risks and low-carbon opportunities. These efforts support large institutional investors.
- TCFD Task Force on Climate-Related Financial Disclosures – This organization works to create and maintain climate-related financial-risk disclosures that are both voluntary and consistent. These disclosures support companies, asset managers, and asset owners.
- Global Reporting Initiative and the Global Sustainability Standards Board – These organizations develop and maintain standards for the measurement of an organization's impact on the economy, environment, or people, and contributions to sustainable development.
- Green House Gas ("GHG") Protocol – GHG supplies the most widely used greenhouse gas accounting standards, including definitions of Scope 1, 2, and 3 emissions.

  All other major climate-related reporting standards draw on, and align with, the GHG protocol definitions.

  - Scope 1 standards cover the GHG emissions that a company makes directly—for example, emissions while running company equipment and vehicles.
  - Scope 2 standards cover the emissions the organization makes indirectly—for example, power usage purchased to electrify buildings that it owns. This identifies emissions being created on behalf of the entity.
  - Scope 3 standards are all the emissions associated (not with the company itself) but that the organization is indirectly responsible for, up and down its value chain.

    An example would be emissions produced from purchased products from suppliers, or conversely, the emissions produced by products sold by the organization to others. It is a category that draws litigation.

ESG Through a Lens

It is not enough to observe changes in an entity's ESG inputs or outputs. The practitioner may look at the interactions across a variety of connected viewpoints.

The A4S model describes these in terms of a viewer's lens, as presented below:

- Policy Lens – This is in reference to climate policies, carbon pricing, and regulations that encourage sustainable business operating changes. These policies may lead to increased costs and complexity for the organization.

- Legal Lens – This is in reference to litigation that could occur involving parties who claim loss or damage from the effects of climate change. These organizations end up seeking compensation from those that they hold responsible.

  The list of potential claims could allege climate negligence (willful actions that cause harm), failure to act on evidence, and a public company's failure to disclose material risks.

- Technology Lens – This is in reference to the disruption driven by the development of new technology, specifically to support a low-carbon economy.

  In broader terms, the pace of technology development that has the potential to affect the magnitude of climate policy response by lowering the required future carbon price.

  Given the high degree of uncertainty in estimating future technology costs and deployment, it becomes increasingly important to monitor ongoing progress.

  One method is through a regular review of cost projections for renewables relative to fuels.

- Market Lens – This refers to supply and demand changes from economic and social factors.

  These include changing consumer preferences, environmental impact of resources used, competitor landscape, and uncertainty in market signals.

- Reputational Lens – This is in reference to how a firm's reputation impacts value.

In addition, ESG changes often affect risks and opportunities outside the expected scope.

The A4S ESG Framework

The A4S ESG framework, much like other frameworks observed, follows a scientific method, building upon measurable data, economic relevance, and potential likelihood.

Using the A4S framework, and following a series of five steps, valuation analysts can add ESG data findings into their valuation process.

The steps are as follows:

1. Identify the key value drivers of the organization. Identifying the key business value drivers assists in finding which climate-related risks or opportunities the company is exposed to, and what adjustments, if any, should occur to the valuation.

2. Assess the sources of ESG risks and opportunities. Once key drivers have been identified, an assessment of ESG risks and rewards can occur. This includes identifying existing or potential sources of mitigation or enablement and relating those findings to the key drivers.

   The process often includes discussions with management, review of corporate reporting, external data providers, equity analyst reports, credit rating agencies, geospatial data, and sector-specific ESG reporting.

3. Filter the assessed ESG risks. All relevant risks and opportunities should be examined for both likelihood and materiality. A ranged value is applied to both likelihood and materiality, to be used in the valuation adjustments to come.

   Using available information and best judgement, the practitioner should arrive at both expected and significant ESG impacts.

   Some examples of filtering questions could include the following:

   a. What are the costs of reacting to an ESG change after it has occurred?

b. What is the cost to mitigate before change occurs?

c. What are the revenue opportunities operating in a new market?

d. How soon will the ESG change occur (in years, months)?

4. Integrate (where appropriate) the risks and opportunities into valuation models. This should include both the income and the market approaches to value.

   Once the risks and opportunities associated with climate change have been filtered, the next point for consideration is how those risks and opportunities translate to value.

   The decision whether to include climate change risks and/or opportunities in either the discount rate or cash flow is affected by the ability to quantify and reflect the risk in cash flow, the reliability of estimates used to perform that quantification, and the certainty with which the risks will affect the business.

   Generally, as quantifiability, reliability, and certainty of risks and opportunities increase, it is preferable to include these risks/opportunities in the cash flow rather than the discount rate.

   Certain risks and opportunities may affect the discrete cash flow, the terminal value considerations, or both, depending on the time horizon of the forecasts and the climate change impacts.

   When adjusting the discount rate, it is important to assess whether the risk or opportunity presented exists industry wide. If so, it could already be priced into the discount rate by the market.

   At the current time, there has been little evidence that the market is pricing in these risks and opportunities.

   As climate change increasingly becomes a focus, it is likely to be considered and priced in by the market. It is important to ensure no double counting of risks or opportunities occurs among the discrete cash flow, terminal value, or discount rate assessment.

5. Perform triangulation. This process examines the risks or opportunities and their related impact on the subject entity versus its peers.

   Once the climate change risks and opportunities have been assessed, it is important for the practitioner to assess the estimated value of the subject entity in relation to market considerations.

   Triangulation also includes iteration over time as risks and opportunities become more apparent and quantifiable with the improvement in data, disclosures, and information.

   Considerations relating to terminal value, holding period, and exit strategy may be particularly sensitive to climate change risks, since climate change effects are expected to increase significantly in the decades to come.

   Many cash flow forecasts are of shorter lengths (5 to 10 years) and may not fully reflect long-term climate change risks if near- term impacts are not as significant.

   It is important to consider the inherent assumptions within the terminal value analysis such as the perpetual growth rate or a constant discount rate.

   Businesses or assets may become stranded in the long term, and a perpetual going-concern assumption may not be appropriate. Investors in businesses more heavily exposed to climate change risks in the long term may face challenges in realizing desired exit strategies.

A4S Rationale for Adjustments

Adjusting the Discount Rate

An adjusted discount rate may be applied when the analyst cannot easily or reliably quantify the impact of climate change on the business. Such an adjustment may be appropriate if the analyst's belief is that it will probably have a significant impact on value and that the discount rate can be reasonably estimated.

The quantification of the adjustment may be implied by performing cash flow sensitivities. Arriving at a reasonable sensitivity analysis to quantify the discount rate adjustment could be challenging where uncertainty is high.

Scenario analysis may be used to reflect this uncertainty.

Adjusting the Cash Flow and/or Terminal Value

Climate change can affect all elements of the cash flow, including revenue, costs, and capital expenditures. The practitioner should be alert for regulation

that is affirmed in law, as well as moderate uncertainty around timing and quantification.

Highly measurable and certain, immediate, and known impact to cash flow should be calculated.[5]

The International Valuation Standards Council

The International Valuation Standards Council ("IVSC") follows a different format/framework for the inclusion of ESG data in valuation. The IVSC states that ESG disclosures are typically nonfinancial by nature and, therefore, do not have a financial impact.

In the IVSC framework, specifically in the market approach, the IBSC suggests a three-step method:

1. Assess the relevant ESG criteria for a given sector
2. Compare the performance of the subject company to such criteria
3. Calibrate the valuation parameters (such as market multiples) to the subject company to consider its relative performance against market peers based on selected ESG criteria

In the IVSC framework, specifically in the income approach, the challenge to incorporate ESG criteria assessment comes from the reliability of future cash flow and the inherent risks that management (in their efforts to achieve their forecasts) might coax data.

As in the A4S framework, an important point of attention is avoiding double counting of ESG valuation impacts. ESG risks and opportunities may or may not be already reflected in the forecast business plan.[6]

Summary and Conclusion

Globally, the modeling and application of ESG data in business valuation continues to increase. The number of governing bodies has remained stable, but look to be consolidating.

ESG methodologies have found a consistent form, and the available data to build and support conclusions continues to improve.

Based on reporting trends in Europe, the future of ESG reporting and usage in U.S. business valuation may continue to expand.

Global Legislation and Valuation Guidance—Supplemental

There is a great deal of legislation and guidance available on ESG methods.

The following is a sampling of guidance either queued for passage or already in use. The European governing agencies are currently much more rigorous than U.S. agencies, but trends indicate that there is a leveling of activities and expectations of governing agencies moving forward, with greater structure and guidance likely for the U.S. market.

Summarized below are various directives from a range of authoritative organizations.

EU Corporate Sustainability Reporting Directive

- Make reporting information material for enterprise value creation in the management report mandatory.
- Increase the current scope to include large undertakings with greater than 250 employees, as already defined in the accounting directive.
- Strengthen linkages between nonfinancial and financial information by ensuring the implementation of the Task Force on Climate-Related Financial Disclosures recommendations, including information on the financial impacts of climate on the business.[7]

Global ESG Disclosure Standards for Investment Products, CFA Society

If investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return, then the investment manager must disclose the following:

- The impact objectives in measurable or observable terms
- The stakeholders who will benefit from the attainment of the impact objectives
- The time horizon over which the impact objectives are expected to be attained
- How the impact objectives are related to other objectives that the investment product has and how the pursuit of the impact objectives could result in trade-offs with those other objectives
- How the attainment of the impact objectives will contribute to third-party sustainable development goals if there is a stated intention to do so

- The proportion of the portfolio committed to generating social and environmental impact
- How the impact objectives are expected to be attained
- The risks that could significantly hinder the attainment of the impact objectives, should they occur
- How progress toward, or attainment of, the impact objectives is measured, monitored, and evaluated
- How progress toward the attainment of the impact objectives is reported to investors
- The process for assessing, addressing, monitoring, and managing potential negative social and environmental impacts that may occur while attaining the impact objective[8]

UNEP-FI IIF-TCFD Report Playbook

- Disclosure of temperature scenarios (e.g., 1.5°C, 2°C, 4°C, etc.) and time frames (these temperature scenarios are standardized across the world, with most climate predictions utilizing these increments.)
- Disclosure of economic transition scenarios (e.g., orderly, disorderly, middle-of-the-road)
- Discussion of the climate model review process, as well as justification for choosing a climate model and provider
- Socioeconomic with regard to population peak, migration, gross domestic product growth, employment rate and discount rate
- Energy with regard to oil demand, fossil fuel use, reverse emissions, renewable usage, and projected energy mix by decade when possible
- Policy with regard to carbon tax with some form of regional granularity and subsidies for renewable energy sources
- Discussion of results of scenario analysis on specific industries, using quantitative variables when possible and relevant time frames
- Attempt portfolio impact assessment based on analyses of individual industries
- Disclosure of temperature scenarios used as well as time frames:
  - Discussion of data used, sources of data, and relevant tools used to calculate physical risks
  - Analysis of extreme weather events, including:
    - types of extreme weather events analyzed
    - tangible impact of extreme weather event (e.g., period of inoperability, asset loss)
    - relationship between tangible impact of extreme weather event and revenue
  - Incremental changes in weather, including:
    - changes in sector productivity
    - relationship between changes in productivity and revenue
  - Discussion of combined revenue/production loss due to physical risks, as well as an evaluation of whether the losses stemmed mainly from incremental or extreme changes in weather.[9]

Notes:

1. Svea Herbst-Bayliss, "Little Engine No. 1 Beat Exxon with Just $12.5 Mln - Sources," Reuters (June 29, 2021).
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8. "Global ESG Disclosures Standards for Investment Products," CFA Institute (2021).
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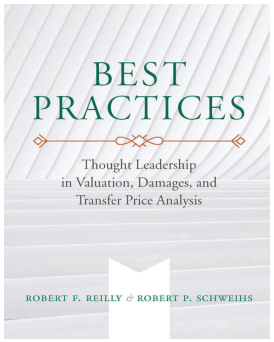

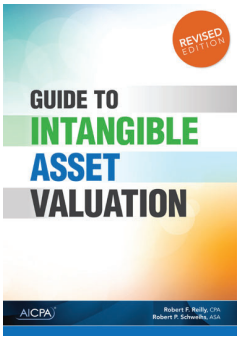

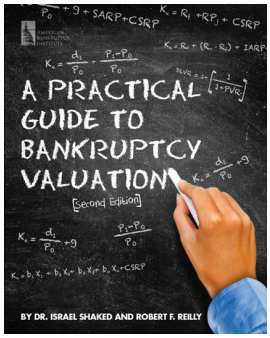

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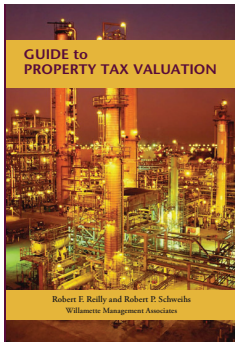

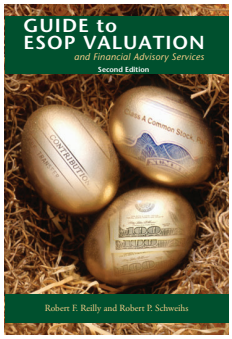

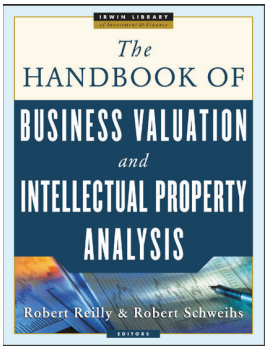

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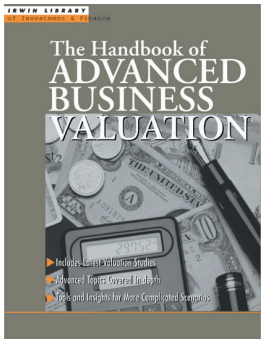

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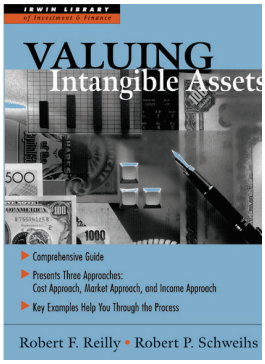

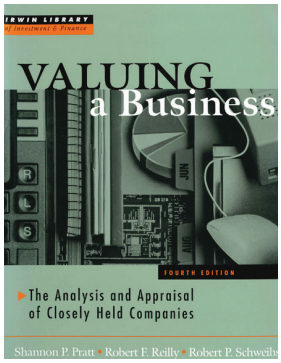

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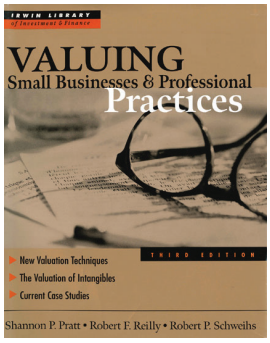

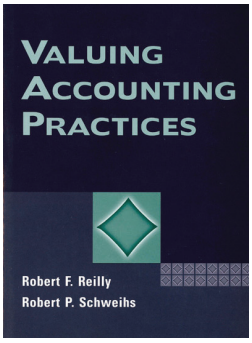

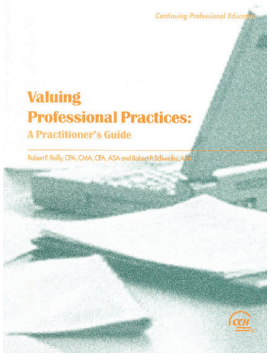

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Willamette Management Associates
A CITIZENS COMPANY

Estimating the Blockage Discount in the Fair Market Value of Publicly Traded Company Restricted Stock

Chad M. Kirkland

In valuations developed for gift tax, estate tax, and generation-skipping transfer tax purposes, the fair market value of publicly traded stock may become a controversial issue. Such controversy may arise when the ownership interest of the publicly traded stock is restricted. And, such controversy may arise when the subject block of stock is so large relative to the stock's daily trading volume that it cannot be sold in open market transactions at the quoted trading prices without exerting negative price pressure on the stock. This discussion summarizes the factors to consider and the procedures that are generally relied on to develop an analysis of the difference between (1) the price of the block of stock based on the quoted stock price and (2) the fair market value of the subject block of stock. This value difference is typically referred to as the blockage discount.

Introduction

The fair market value of 100 shares of publicly traded stock may be approximated by the formula: fair market value = stock price[1] × number of shares of stock.

The fair market value of 100,000 shares of stock may be approximated by the same formula.

However, as the number of shares in the subject block of stock increases, that formula becomes incomplete and it may overstate the fair market value of the shares. This result occurs when the block of stock is so large relative to the daily trading volume that it cannot be sold over a short time period without depressing the market price of the stock (i.e., it suffers from "blockage").

In these circumstances, the fair market value of the block of stock is typically estimated as follows:

	Stock price[2]
×	Number of shares owned
×	(1 – Estimated blockage discount)
=	Fair market value of the subject block of stock

In the above formula, the only variable that is not known is the blockage discount.

As the number of shares in the subject block continues to increase, the stock price multiplied by shares outstanding formula may underestimate the fair market value of the ownership interest. This is because of the ownership control inherent in the shares.

This discussion focuses on situations where an ownership interest in stock is large enough to be affected by blockage—but is small enough that it does not include the economic benefits of ownership control.

Valuation analysts are often asked to estimate the fair market value of blocks of publicly traded stock for many purposes. The purpose for such valuations can include valuations developed for gift tax filings, estate tax filings, generation-skipping transfer tax filings, income tax filings, corporate planning, or other purposes.

This discussion (1) provides an overview of the concept of blockage, (2) considers terms of Securities and Exchange Commission ("SEC") Rule 144 that affect blockage, (3) lists factors that may be considered in a blockage discount analysis,

and (4) presents generally accepted methods and procedures to estimate the amount of the blockage discount.

The Concept of Blockage

Market prices for publicly owned stock typically reflect the trading of relatively small blocks of a few hundred to a few thousand shares. A small block of stock typically enjoys instant marketability since it is relatively easy to find a willing buyer or a willing seller on the other side of the trade.

In contrast, large blocks of stock typically do not share this type of ready marketability.

Evidence exists that it is more difficult for a shareholder to sell a very large block of company stock compared to an otherwise identical small block of company stock. The price discount to account for the negative marketability factors associated with owning a large block of stock is often referred to as a "blockage discount."

Blockage discounts are, in effect, a type of valuation discount for lack of marketability, and such valuation discounts are typically associated with large blocks of publicly traded stock.

The theory behind blockage discounts is intuitive—the larger a block of stock owned by a single shareholder (or a collective shareholder group), the smaller the potential pool of buyers is likely to be, and the more difficult it is likely to be to sell that block of stock.

Therefore, it may take longer to sell a large block of stock and it may be more difficult to do so.

The *Stout Restricted Stock Companion Guide* describes this concept and states, "All else being equal, large blocks of unregistered stock (expressed as a percentage of total shares outstanding) are more illiquid than small blocks. This results from: (i) Rule 144's volume limits after the initial required holding period and prior to the ultimate holding period; and (ii) the difficulty in disposing of a large block of stock in a short period through public sales due to general market supply and demand conditions."[3]

Both the American Institute of Certified Public Accountants *Statement on Standards of Valuation Services* and the American Society of Appraisers *Business Valuation Standards* define the valuation blockage discount as "an amount or percentage deducted from the current market price of a publicly traded stock to reflect the decrease in the per share value of a block of stock that is of a size that could not be sold in a reasonable period of time given normal trading volume."

The Treasury Regulations ("Regulations") also recognize blockage discounts. According to Regulations Section 20.2031-2(e):

> In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an under writer, may be a more accurate indication of value than market quotations.

"When blockage exists in a subject block of stock, it cannot be sold immediately in the open market at the existing market price for the stock."

In valuation analyses developed for transfer tax planning and compliance purposes, fair market value is defined as "the price at which such property would change hands between a willing buyer and a willing seller, with neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[4]

This definition affects how valuation analysts consider and estimate the blockage discount.

When blockage exists in a subject block of stock, it cannot be sold immediately in the open market at the existing market price for the stock.

Therefore, the "hypothetical willing buyer" of the block of stock that is contemplated in the aforementioned fair market value definition would demand a lower price than that resulting from the stock price multiplied by shares formula.

The blockage discount definition presented above is limited to large blocks of publicly traded stock. That issue is the subject of this discussion. However, it is noteworthy that other assets and interests can suffer from blockage as well.

For example, in the case of nonpublic stock, this phenomenon occurs when the value of the subject block of nonpublic stock is so large that it significantly reduces the number of potential buyers for the subject block of stock.

A large block of nonpublic stock with an undiscounted value of $5,000 will attract more potential

buyers than a large block of nonpublic stock worth $500,000,000, all other factors being equal.

This reduced liquidity is often considered and accounted for as a component of the discount for lack of marketability, but it is conceptually similar to a blockage discount.

SEC Rule 144: Selling Restricted and Control Securities

Restricted securities are securities acquired in unregistered, private sales from an issuer or from an affiliate of the issuer. Investors typically receive restricted securities through private placement offerings, Regulation D offerings, employee stock benefit plans, as compensation for professional services, or in exchange for providing start-up capital to the company.

Control securities are those held by an affiliate of the issuing company. An affiliate is a person, such as a director or a large shareholder, in a relationship of control with the issuer.

Control means the power to direct the management and policies of the company in question, whether through the ownership of voting securities, by contract, or otherwise.

Securities purchased from a controlling person or affiliate, even if the securities were not restricted in the affiliate's hands, are deemed restricted securities.

Under Section 5 of the Securities Act of 1933 (the "1933 Act"), all offers and sales of securities must either be registered with the SEC or qualify for some exemption from the registration requirements. If an investor acquired restricted securities or holds control securities, the investor must find an exemption from the SEC's registration requirements to sell them in the marketplace.

Rule 144 allows for the resale of restricted and control securities if certain conditions are met.

Conditions of Rule 144

If an investor wishes to sell its restricted or control securities to the public, the investor can follow the applicable conditions set forth in Rule 144. The rule is not the exclusive means for selling restricted or control securities, but it provides a "safe harbor" exemption to sellers.

The five conditions of Rule 144 are summarized below:

1. Holding Period – Before an investor may sell any restricted securities in the marketplace, the investor should hold them for a certain period of time. If the company that issued the securities is subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), then the investor must hold the securities for at least six months.[5]

   If the issuer of the securities is not subject to the reporting requirements, then the investor should hold the securities for at least one year. The relevant holding period begins when the securities were bought and fully paid for. The holding period only applies to restricted securities.

   Since securities acquired in the public market are not restricted, there is no holding period for an affiliate who purchases securities of the issuer in the marketplace.

   However, the resale of an affiliate's shares as control securities is subject to the other conditions of the rule.

2. Adequate Current Information – There must be adequate current information about the issuer of the securities before the sale can be made.

   This condition generally means that the issuer has complied with the periodic reporting requirements of the Exchange Act.

3. Trading Volume Formula – If you are an affiliate, the number of equity securities you may sell during any three-month period cannot exceed the greater of 1 percent of the outstanding shares of the same class being sold.

   However, if the class is listed on a stock exchange or quoted on Nasdaq, the number of equity securities you may sell during any three-month period cannot exceed the greater of:

   a. 1 percent or
   b. the average reported weekly trading volume during the four weeks preceding the filing a notice of sale on Form 144.

   Over-the-counter stocks, including those quoted on the OTC Bulletin Board and the Pink Sheets, can only be sold using the 1 percent measurement.

4. Ordinary Brokerage Transactions – If you are an affiliate, the sales must be handled in all respects as routine trading transactions,

and brokers may not receive more than a normal commission.

Neither the seller nor the broker can solicit orders to buy the securities.

5. Filing a Notice of Proposed Sale with the SEC – If you are an affiliate, you should file a notice with the SEC on Form 144 if the sale involves more than 5,000 shares or the aggregate dollar amount is greater than $50,000 in any three-month period.

   The sale should take place within three months of filing the form. And, if the securities have not been sold, you should file an amended notice.

Treatment of an Affiliate of a Publicly Traded Company

SEC Rule 144 defines an "affiliate" of an issuer as "a person, such as an executive officer, a director, or large shareholder, that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer."

Furthermore, the term "person," when used with reference to a person for whose account securities are to be sold in reliance upon Rule 144, includes the following:

1. Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person
2. Any trust or estate in which such person or any of the persons specified in paragraph 1 above collectively own 10 percent or more of the total beneficial interest or of which any of such persons serve as trustee, executor, or in any similar capacity
3. Any corporation or other organization (other than the issuer) in which such person or any of the persons specified in paragraph 1 above are the beneficial owners collectively of 10 percent or more of any class of equity securities or 10 percent or more of the equity interest

Factors That Affect the Blockage Discount

Two factors that may influence the size of the blockage discount are as follows:

1. The size of the block
2. The trading volume (whether measured daily, weekly, monthly, or over some other period) of the subject company shares

Therefore, one of the first procedures developed by the valuation analyst in a blockage discount analysis is to review the number of shares comprising the subject block of stock relative to the daily trading volume for the subject company shares.

Typically, this procedure is viewed as a more relevant measure of liquidity with regard to the subject interest than the percentage ownership of the subject company—although that may also have an impact on the fair market value of the subject block of stock.

An analysis of the trading volume may include a comparison of the size of the subject block of stock to the average weekly trading volume of the subject stock during the 12-month period immediately preceding the valuation date.

In addition, the analyst may also consider the size of the block relative to the weekly high volume, the weekly low volume, and the weekly median volume over that 12-month period.

The valuation analyst may also analyze the historical trading activity for the subject company

stock to identify the impact of unusual or nonrecurring events. For example, trading volume can spike concurrent with an earnings announcement, a stock being added to a popular stock index (such as the Russell 2000), or for many other reasons.

If the blockage discount analysis is based on the stock's historical trading volume and the historical trading volume is either unusually high or unusually low in certain periods due to unusual or nonrecurring events, the analyst may normalize the reported historical trading volume in the affected periods.

The valuation analyst may also consider if the subject interest includes restricted securities or control securities. The prior section in this discussion titled, "SEC Rule 144: Selling Restricted and Control Securities," describes the factors to consider for restricted and control securities.

In certain circumstances, state law affects the restrictions or control inherent in the subject block of stock. For example, state statutes may restrict a share's voting rights or affect the subject company's ability to complete a merger or acquisition transaction.

It may be prudent for the valuation analyst to consult with legal counsel to clarify the impact that state law exerts on transfer restrictions with regard to the subject block of stock.

Judicial decisions may provide professional guidance on the relevant factors to consider when estimating the blockage discount.

In the U.S. Tax Court case, *Estate of Foote v. Commissioner,*[6] the valuation analyst for the Internal Revenue Service (the "Service") considered the following factors in his blockage discount analysis:

1. The number of shares in the subject interest relative to the total subject company shares outstanding
2. The number of shares in the subject interest relative to the subject company's daily trading volume
3. The existence of resale restrictions on the subject interest
4. The volatility of the subject company stock
5. The size of the trading "float" of the subject company stock
6. The stock market trend in general
7. The trading market that the stock was traded on (e.g., the Nasdaq or the New York Stock Exchange)
8. The most recent projected earnings trend of the subject company
9. The market price performance of the stock compared to the general stock market
10. The subject company's dividend-paying record
11. The current outlook for the subject company
12. U.S. economic trends
13. The number of subject company shareholders, including institutions
14. The percentage of institutional ownership of the shares of the subject company
15. Whether the stock was a marginable security
16. The stock price movement on days with large trading volume

In *Estate of Murphy v. United States*,[7] the District Court estimated the blockage discount based on consideration of the following qualitative factors:

1. The volatility of the stock
2. The actual price change in the stock under recent and preceding market conditions
3. The subject company's current economic outlook
4. The trend of the price and the financial performance of the stock
5. The trend of the subject company's earnings
6. The existence of any resale restrictions on the stock

In both the *Foote* decision and the *Murphy* decision, the valuation analyst that considered and analyzed the greater list of factors prevailed in the judicial determination.

Methods to Estimate a Blockage Discount

This section presents three generally accepted methods that are often considered for the purpose of estimating a blockage discount.

The information discussed below is focused on control or restricted stock. This is because blocks of stock that suffer from blockage tend to be control or restricted stock.

The methods outlined below also are applicable to subject equity interests that are not restricted.

Every valuation analysis should be based on the facts and circumstances of the individual case.

The purpose of the information presented next is primarily to facilitate an understanding of issues relating to blockage discounts. It is not intended to provide a template to estimate an appropriate level of blockage discount.

The owner of a block of control or restricted stock typically has the following methods of selling the stock:

- Secondary public offering
- "Dribble-out"
- Private placement
- Other methods (not discussed herein)

Secondary Public Offering

One method of selling control or restricted stock is through a secondary public offering. In order to conduct a secondary public offering, a registration statement would be required to be filed under the 1933 Act.

Once the control or restricted stock is sold through a secondary public offering, the shares would no longer be subject to the limitations of Rule 144.

If a secondary public offering were to be relied on to sell a large block of stock in a public company, several factors should be considered.

First, various costs would be incurred for a secondary offering. These costs may include, but would not be limited to, investment banking fees, legal fees, accounting fees, and other professional expenses.

Second, depending on the restrictions inherent in the subject block of stock the subject company would need to file a registration statement and prospectus for the block of shares subject to the offering. It may be the case that the subject company board of directors has sole discretion over this decision.

However, the subject block of stock may have a registration rights agreement with the subject company giving the owner of the subject block of stock the ability to force the subject company to register the subject block of stock.

If the subject company has previously announced special dividends and/or share repurchase programs within a reasonable time prior to the valuation date, the subject company may be less interested in offering new shares, such as through a secondary public offering, as of the valuation date.

Third, a secondary public offering would also be subject to indirect costs form market risk. These market risks may include the following:

1. Stock price fluctuations between the time of the decision to initiate a secondary offering and when the proceeds from the sale are received
2. Stock price dilution due to an increase in the number of shares available for sale
3. The potential negative informational message to the public market that the sale of a large block of subject company shares implies

In addition, secondary public offerings often occur at a price discount from the prevailing publicly traded price of the stock, which would typically reduce the attractiveness of this method as a means of selling a large block of stock.

Fourth, the analyst may consider actual correspondence the shareholder and/or authorized representatives have had regarding a potential offering of the subject shares.

The subject company may have indicated either in the affirmative or negative about its willingness to assist the shareholder with a secondary offering.

Dribble-Out Rule

A second method of disposing of control or restricted stock would be in "dribble-out" sales.

If the subject block of shares is restricted, the dribble-out period may be based on the Rule 144 trading volume formulas, which were previously discussed.

Under the dribble-out provision of Rule 144, the owner of a block of control or restricted stock may sell, during a three-month period, the greater of:

1. 1 percent of the outstanding shares of the same class being sold or
2. the average reported weekly trading volume of the stock during the four weeks preceding the filing a notice of sale on Form 144.

If the subject block of shares is not restricted and the dribble-out method is selected, then the time period can be estimated based on either the guidance in Rule 144 or based on discussions with the stock's market makers.

Market makers may be able to provide the analyst with information about how many additional shares the market could absorb without exerting negative price pressure on the stock.

As discussed previously, sales of control or restricted stock are subject to the other resale provisions as well. The other resale provisions include the following:

1. A required holding period
2. Adequate current information
3. Ordinary brokerage transactions
4. The filing of a notice of proposed sale with the SEC

In addition, "dribble-out" sales may be subject to company-specific insider trading rules and restrictions.

The Black-Scholes option pricing model ("BSOPM") is typically applied to estimate the blockage discount and the fair market value of the subject block of stock relying on a dribble-out method analysis.

This model is discussed in the following section.

Black-Scholes Option Pricing Model

The BSOPM estimates a discount for lack of liquidity using option pricing theory. In particular, this model is based on a put option, which gives the holder the right (but not the obligation) to sell the underlying asset on or by the expiration date at the exercise price.

Typically, the BSOPM is relied on to estimate the price of a series of daily put options that could be used to hedge against any decline in the subject company stock price during the hypothetical period the subject block of stock could be sold into the market (i.e., the "dribble-out period").

The total cost of this hedge as a percent of the freely traded value of the subject block of stock on the valuation date represents the indicated illiquidity discount that is associated with the subject block of stock.

The following discussion summarizes this model.

An option that grants the right to buy an asset is a call option, while the corresponding right to sell an asset is a put option. The BSOPM calculates the price of a put option based on various inputs. The indicated put option price can be interpreted as a cost to insure the current market price of an investment over a period of time.

In other words, the price of a put option shows what investors are willing to pay to guarantee the ability to sell the stock at a predetermined price.

For the purpose of a blockage discount analysis, the price of the put option, with respect to the subject company stock market price on the valuation date, represents the discount that is associated with the shareholder's inability to sell the entire subject block of stock into the market immediately, without severely depressing the market trading price.

In other words, the analyst typically considers a ratio of (1) the price of the put option (or series of put options) to (2) the market trading price of the subject company stock represents the discount for illiquidity.

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

1. the current price of the underlying stock (the current stock 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, and
5. the standard deviation of the annual rate of return on the underlying stock.

The BSOPM for a dividend-paying stock is typically expressed as follows:

$$\text{Put option value (P)} = Xe^{-rt} \times N(-d2) - Se^{-\delta t} \times N(-d1)$$

where:

S	=	Stock price
X	=	Exercise (strike) price
$N( )$	=	Value of cumulative normal distribution at the point ( )
d_1	=	$\frac{ln(S/E) + (r + \sigma^2/2)^t}{\sigma\sqrt{t}}$
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
δ	=	Dividend yield
σ	=	Annual standard deviation of return (usually referred to as *volatility*)

The value of the put option is positively correlated with both the volatility and the time to maturity. As the volatility or the time to maturity increases/decreases, the value of the put option (and the resulting discount for lack of liquidity) also increases/decreases.

The benefits of applying the BSOPM to estimate the blockage discount are as follows:

1. It is based on empirical support.
2. The model parameters are based on observable market data.
3. It is useful in testing discounts.

4. The model has flexibility with varying inputs.
5. It can be easily replicated.

Private Placement Method

Another method of selling a block of control or restricted stock would be in a private placement. A private placement is unlike a public offering because buyers of shares in a public offering acquire stock that is free of restrictions.

In contrast, the buyer of the subject block of stock through a private placement would:

1. acquire the stock subject to the same restrictions currently covering the stock and
2. be subject to a six-month holding period before dribble-out sales could begin.

Unlike a secondary public offering or a dribble-out sale, the buyer of the stock in a private placement transaction would not acquire the stock free of Rule 144 restrictions.

Specifically, if the seller of the subject block of stock is an affiliate of the subject company and the subject block of stock represents control shares, the buyer of the stock in a private placement would be subject to the initial six-month holding period under Rule 144.

As a result, the price that a buyer of restricted or control stock is willing to pay in a private placement is generally less than the public price of an otherwise identical security because the buyer is acquiring stock that lacks immediate marketability.

Although a private placement might offer a short-term path to liquidity, the associated restrictions with a private placement transaction indicates that the seller of the subject block of stock would likely have to accept a lower price for its shares.

In contrast, the dribble out method, as discussed above, offers a path to liquidity, but without the additional restrictions associated with private placement.

Nonaffiliate Purchaser

If a nonaffiliate were to purchase restricted stock from another nonaffiliate, the purchaser would be able to "tack on" the seller's initial required holding period.

However, if a nonaffiliate were to purchase restricted stock from an affiliate, a buyer of the subject block of stock through a private placement of the stock would still be subject to the initial six-month holding period because the stock would be purchased from an affiliate or affiliates.

After completion of the six-month holding period, the nonaffiliate purchaser would be able to resell the stock in compliance with Rule 144(c).[8]

More specifically, the nonaffiliate would not be required to comply with the trading volume, brokerage transaction, and notice conditions for reliance on the Rule 144 "safe harbor" exemption after the required six-month holding period.

The nonaffiliate would only have to comply with the adequate current publication requirement described in Rule 144(c).

After one year, the nonaffiliate purchaser would be permitted to sell the entire block of stock free of any restrictions, including Rule 144(c).

However, there is no guarantee that market conditions would allow for such a sale to take place, or that if the sale were to take place, it would occur at the full and freely traded market price.

Affiliate Purchaser

Alternatively, if the buyer of the subject block of stock through a private placement were an affiliate, the buyer would still be subject to the initial six-month holding period.

After completion of the six-month holding period, the affiliate purchaser would be able to resell the stock, but only in compliance with all Rule 144 conditions, such as the following:

1. The adequate current public information conditions under Rule 144(c)
2. The trading volume limitations under Rule 144(e)
3. The ordinary broker transactions requirement under Rule 144(f)
4. The filing notice with the SEC requirement under Rule 144(h)

SEC Institutional Investor Study

Pursuant to Congressional direction, the SEC undertook an analysis of the purchases, sales, and holding of securities by financial institutions in order to determine the effect of institutional activity upon the securities market. The study report was published in eight volumes in March 1971.

The fifth volume provides an analysis of restricted securities and deals with such items as the characteristics of the restricted securities purchasers and issuers, the size of transactions (dollars and

shares), the lack of marketability discounts on different trading markets, and their sale provisions.

This research project provides some guidance for measuring the price discount on privately placed shares in that it contains information based on the actual experience of the marketplace.

This research showed that, during the period surveyed (January 1, 1966, through June 30, 1969), the amount of discount allowed for restricted securities from the trading price of the unrestricted securities was generally related to the following four factors:

1. Earnings – Earnings and sales consistently have a significant influence on the size of restricted securities discounts according to the study. Earnings played the major part in establishing the ultimate discounts at which these stocks were sold from the current market price.

   Apparently earnings patterns, rather than sales patterns, determine the degree of risk of an investment.

2. Sales – The dollar amount of sales of issuers' securities also has a major influence on the amount of discount at which restricted securities sell from the current market price.

   The results of the study generally indicate that the companies with the lowest dollar amount of sales during the test period accounted for most of the transactions involving the highest discount rates, while they accounted for only a small portion of all transactions involving the lowest discount rates.

3. Trading Market – The market in which publicly held securities are traded also reflects variances in the amount of discount that is applied to restricted securities purchases.

   According to the study, discount rates were greatest on restricted stocks with unrestricted counterparts traded over-the-counter, followed by those with unrestricted counterparts listed on the American Stock Exchange, while the discount rates for those stocks with unrestricted counterparts listed on the New York Stock Exchange were the lowest.

4. Resale Agreement Provisions – Resale agreement provisions often affect the size of the discount. Certain provisions are often found in agreements between buyers and sellers that affect the size of discounts at which restricted stocks are sold.

   These provisions may include "piggyback" registration rights or demand registration rights.

In Revenue Ruling 77-287, the Service acknowledged the conclusions of the SEC Institutional Investor Study and the prices of restricted securities purchased by investment companies as part of the "relevant facts and circumstances that bear upon the worth of restricted stock."

The Service described the purpose of Revenue Ruling 77-287 as, "to provide information and guidance to taxpayers, [the Service], and others concerned with the valuation, for Federal tax purposes, of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal security laws."

Application of the Private Placement Method

In developing an analysis that relies on the private placement method to estimate a blockage discount for a large block of stock, it is typical for analysts to rely on guideline private placement transactions of restricted stock of companies that had identical securities traded on a public stock market exchange.

Since shares of restricted stock are not immediately marketable, such private placements of restricted stock generally occur at a price below the concurrent market price of the actively traded shares.

These private transactions enable the analyst to compare:

1. the prices of shares which may not be immediately traded in a public market due to restrictions and
2. the concurrent market price of their publicly traded counterparts.

As a result, these guideline private placement transactions provide an indication of the lack of marketability inherent in restricted shares compared to their freely traded counterparts.

Analysts can rely on numerous databases to search for guideline private placement transactions of restricted stock. It should be noted that many of the guideline private placement transactions may have occurred prior to 1997.

For these transactions, the required holding period for the stock that was acquired pursuant to Rule 144 was two years.

Following the two-year holding period, the holder of the stock was allowed to dribble the stock into the public market, subject to certain volume limitations.

Effective April 29, 1997, the SEC changed the minimum required holding period under Rule 144 from two years to one year. As a result, any guideline private placement transactions that occurred after 1997 incorporate a one-year required holding period.

The SEC then made another change to the required holding period for privately placed stock. Effective February 15, 2008, the required holding period was reduced from one year to six months.

Assuming the valuation date of the blockage discount analysis is after February 15, 2008—that is, as of a date when the required holding period was six months—it may be necessary to make a downward adjustment to the analyst's concluded price discount.

That adjustment should account for a reduction in the required holding period if the majority of the guideline private placement transaction data reflect a required holding period of one or two years.

Summary and Conclusion

Determining the blockage discount to apply in estimating the fair market value of large block(s) of publicly traded stock requires consideration of assignment-specific facts and circumstances and generally accepted valuation methodology.

The valuation methodology selected, and its application, may also be influenced by trading volume history and considerations, discussions with market makers and counsel, and judicial precedent, among other factors.

The analyst should make sufficient inquiries of the subject publicly traded company and the owner of the large block of stock in the subject publicly traded company (to the extent possible) and should conduct sufficient research to understand the various alternatives available for the transfer of the subject interest.

In a blockage discount analysis, a valuation analyst may consider the realistic alternatives to selling the large block of stock. Those alternatives may include:

1. selling the stock in a secondary public offering,
2. dribbling out the block of stock in the open market,
3. selling the stock in a private placement, and/or
4. some other method.

Notes:

1. For gift and estate tax valuations, the stock price may be defined as ((high price on the valuation date + low price on the valuation date) ÷ 2). For other valuation purposes, the stock price may be the daily closing price, or some other measure.
2. Ibid.
3. *Stout Restricted Stock Companion Guide* (Stout Risius Ross, LLC, 2021).
4. Treas. Reg. Section 20.2031-1(b).
5. The SEC changed the initial required holding period from one year to six months effective February 15, 2008.
6. Foote v. Commissioner, T.C. Memo 1999-37 (Feb. 5, 1999).
7. Estate of Murphy v. United States, No. 07-CV01013, 2009 WL 3366099 (W.D. Ark. Oct 2, 2009).
8. Rule 144(c) states that adequate current public information about the issuer of the stock being sold must be available before any sale can be made. Generally, this condition is satisfied when the issuer has complied with the periodic reporting requirements of the Exchange Act.

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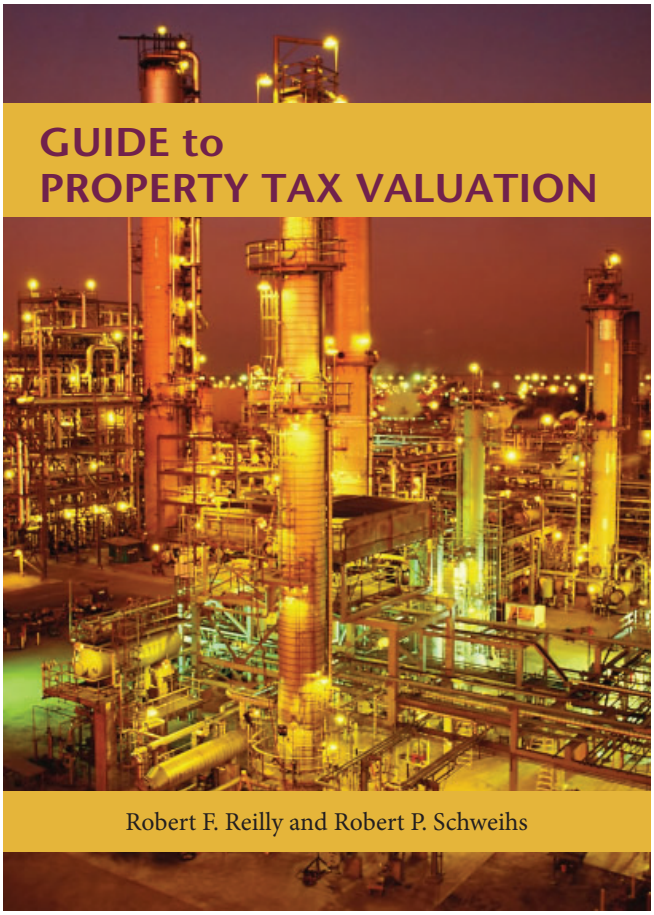

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GUIDE TO PROPERTY TAX VALUATION

Robert F. Reilly and Robert P. Schweihs

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Noncompete Agreement Taxation and Valuation Considerations in Corporate Acquisitions

Robert F. Reilly, CPA

Corporate acquirers expect certain contractual protections for their investments in merger and acquisition ("M&A") transactions. Typically, acquirers expect sellers to enter into noncompetition agreements as part of the M&A transaction. This acquirer expectation relates to the sale of a subsidiary target company by a parent corporation, and this acquirer expectation relates to the sale of a private target company by the selling stockholder/employees. There are legal considerations to the transaction counterparties related to the structuring of the noncompete agreement provisions. And, there are taxation considerations for the transaction counterparties related to the valuation of the noncompete agreement provisions. Valuation analysts ("analysts") who advise in M&A transactions should be aware of both the taxation considerations and the valuation considerations related to noncompete agreements. Analysts can assist the transaction counterparties and their legal counsel by developing noncompete agreement fair market valuations that may be used for both (1) the seller's transaction sale price allocation and (2) the acquirer's transaction purchase price allocation.

Introduction

Corporate acquirers typically expect that seller noncompete agreements will be part of the corporate acquisition structure. This transaction structuring statement is true in most business acquisitions. And, this transaction structuring statement is particularly true in the acquisition of a professional services business.

If the seller of the target company is a parent corporation, then the buyer may expect a noncompetition agreement from the corporate seller. In other words, the buyer does not want the seller corporation to compete with the target company during the term of the noncompete agreement.

The buyer may not want to risk its investment in the target company with regard to either:

1. the seller's development of a competitive start-up venture or
2. the seller's acquisition of an established business in the target's industry.

If the target company sellers are individuals (and, particularly, target company employee/shareholders), then the buyer may expect a noncompetition agreement directly with the selling shareholders.

In other words, the buyer may not want the selling employee/shareholders to take the target company sale proceeds and start, acquire, or work for another competing company in the target's industry.

This discussion focuses on the situation where:

1. the target company is a private corporation and
2. the sellers are employee/shareholders.

This discussion summarizes the taxation and other structuring considerations related to a transaction where employee/shareholders are selling the private C corporation stock to a C corporation acquirer.

Some of the taxation and other structuring considerations discussed herein also apply to the corporate acquirer's purchase of the corporate subsidiary stock of a parent corporation seller. However, the principal focus of this discussion will be taxation and valuation guidance related to the employee/shareholders' sale of a private corporation.

Noncompete Agreements

If there is a noncompetition provision in the transaction stock purchase agreement or the transaction asset purchase agreement, then that provision is typically referred to as a noncompete or noncompetition covenant.

If there is a separate contract between the transaction counterparties (outside of the stock purchase agreement or the asset purchase agreement), then that contract is typically referred to as a noncompete or noncompetition agreement.

However the contract provisions are structured, the objectives of the transaction counterparties are the same. The sellers want to sell the target company and receive the sale transaction proceeds.

The acquirer wants to protect its investment in the acquired target company. Accordingly, the sellers agree not to compete in the industry or profession of the target company for a specified period of time.

Noncompete agreements are individually negotiated, and they vary as to the following terms and provisions:

1. The definition of the target industry, industry segment, or profession
2. The definition of competition or noncompetition (versus, for example, nonsolicitation)
3. The term or length of the noncompetition period
4. The geographic area covered by the noncompetition agreement
5. The penalties for intentional or unintentional violations of the noncompetition provisions

Noncompete agreements are considered to be contracts under state law. Each state may have its own interpretation of what noncompete agreement provisions are considered reasonable and enforceable under that state's laws. Accordingly, legal counsel for each of the transaction counterparties should carefully draft and review the noncompete agreement terms and provisions.

This discussion is not intended to provide legal advice. Rather, this discussion solely considers the taxation and valuation considerations of the noncompete agreement during the transaction negotiation process.

Typically, the consideration paid by the buyer to the sellers for the noncompete agreement is not part of the transaction purchase price paid for the stock of the C corporation target company.

The noncompete agreement with the sellers is generally considered to be an amortizable intangible asset that is separately acquired by the buyer. The value of that intangible asset is separate from the value of the target company stock that is acquired by the buyer.

The noncompete agreement intangible asset is generally amortizable by the buyer over a 15-year amortization period under Internal Revenue Code Section 197(d). The payments received by the employee/shareholders as consideration for the noncompete agreement are typically considered to be ordinary income (and not capital gain) to the sellers.

Therefore, the allocation of the total transaction consideration between the target company stock and the noncompete agreement is typically an important consideration to both the buyer and the sellers.

This total transaction consideration allocation is often an area of disagreement between the Internal Revenue Service (the "Service") and both sets of transaction counterparties.

Amortization of the Noncompete Agreement

Under Section 197(d), a noncompete agreement either with a parent corporation seller or with selling shareholders/employees should be amortizable by the acquirer over a 15-year cost recovery period.

However, Section 197(d)(1)(E) indicates that a noncompete agreement is not a Section 197 intangible asset if the agreement is not entered into "in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portions thereof."

Therefore, a noncompete agreement entered into directly by the acquirer with the target company nonshareholder employees should not be considered a Section 197 intangible asset.

Accordingly, such nonselling shareholder noncompete agreements should not be amortized over 15 years. Rather, the acquirer should expect to be able to amortize such a noncompete agreement over the contract term of the agreement.

Typically, such noncompete agreement contract terms are fairly short-term—such as two or three years. Nonetheless, the Service may take the position that all of the transaction-related noncompete agreements should be amortized over 15 years.

Even though the counterparties to the noncompete agreements are not the sellers, the Service may claim that the agreements were entered into as part of the business acquisition.

This Service position will not change the value of the nonseller noncompete agreements. But, it will spread out the acquirer's amortization income tax deductions over a longer time period.

The courts have concluded that seller noncompete agreements should be amortized over the Section 197 15-year period.

The First Circuit affirmed such a Tax Court decision in *Recovery Group, Inc. v. Commissioner.*[1] In *Recovery Group*, the Tax Court ruled that a noncompete agreement related to the redemption of a 23 percent block of S corporation stock was a Section 197 intangible asset. Even though the noncompete agreement had a one-year contractual term, the Tax Court ruled that the cost of the agreement had to be amortized over 15 years.

In *Recovery Group*, the Tax Court (and the Court of Appeals) concluded that any noncompete agreement payment related to the purchase or redemption of stock should be amortized over the Section 197 15-year period—regardless of the contractual term of the noncompete agreement.

Tax Incentives to Understate the Value of the Noncompete Agreement

Some acquirers may have an economic incentive to understate the target company's purchase price allocation to any seller noncompete agreement. This incentive occurs because the noncompete agreement value will be amortized over 15 years.

Many other categories of target company assets may be depreciated over much shorter periods. Acquirers will typically receive cost recovery on the target company's receivables and inventory in the year after the acquisition.

Acquirers are typically able to depreciate the target company's machinery and equipment over periods of less than 15 years.

Such acquirers may have an economic incentive to understate the allocation of the target company purchase price to any seller noncompete agreement. The acquirer will amortize the fair market value allocated to the noncompete agreement intangible asset over a relatively long 15-year period.

For this reason, the Service may challenge the amount of the total transaction consideration that the acquirer allocates to any seller noncompete agreement.

The Service may claim that the allocation was understated—and that the actual fair market value of the agreement is greater than the amount recognized by the acquirer.

The selling shareholders may also have an economic incentive to understate the target company purchase price allocation to the noncompete agreements. Noncompete agreement payments received by the sellers are treated as ordinary income to them.

In contrast, payments received by the sellers for the target company stock (a capital asset) or for the target company real estate, equipment, or goodwill (Section 1231 assets) are treated as capital gains to the sellers.

So, if both the acquirer and the selling shareholders have an economic incentive to understate the purchase price allocation to any noncompete agreements, the Service will likely scrutinize the value assigned to that intangible asset. In particular, the Service may challenge any transaction where little or none of the target company purchase price is allocated to any seller's noncompete agreement.

Depending on how the transaction is structured, the Service realizes that the acquirer may be indifferent as to a purchase price allocation to goodwill or to the noncompete agreement.

To the acquirer, these two categories of assets are both Section 197, 15-year amortization intangible assets. To the selling shareholders amount of the purchase price allocated to the noncompete agreement results in ordinary income—while the goodwill (a capital asset) allocation results in a capital gain.

Tax Incentives to Overstate the Value of the Noncompete Agreement

Because of the relatively lengthy 15-year amortization period, acquirers may have the above-described incentive to understate the noncompete agreement value in:

1. Section 1060 asset purchase transactions or
2. stock purchase transactions that qualify for the Section 338 election (i.e., that are treated as an asset purchase transaction).

In contrast, in stock purchase transactions that do not qualify for the Section 338 election, the acquirer has an economic incentive to overstate the value of any seller noncompete agreements.

In the typical stock purchase transaction, the acquirer receives a carryover tax basis in the target company assets. That is, the acquirer does not get to depreciate or amortize any purchase price premium paid in excess of the target assets' tax basis.

In such a transaction structure, the acquirer has an incentive to overstate the total consideration allocation to the noncompete agreements.

Instead of a zero cost recovery of the purchase price premium, the acquirer may amortize the purchase price allocated to the Section 197 noncompete agreements over 15 years.

In such a transaction structure, the Service may carefully scrutinize the amount of the purchase price allocated to any seller noncompete agreements. The Service may claim that the amount of the purchase price allocation claimed by the transaction parties is greater than the actual fair market value of the seller noncompete agreements.

The Substance of the Noncompete Agreement

The Service's position may be that, in acquisitive transactions, noncompete agreements only have value when the seller has an actual capacity to compete with the target company.

In assessing the fair market value of the selling shareholder/employee's noncompete agreement, the Service typically considers the seller's capacity to compete based on such factors as age, health, financial ability, technical expertise, industry contracts, regulatory or other restrictions, and geographic proximity.

In addition, in assessing the fair market value of the seller's noncompete agreement, the Service typically looks for one of the following conditions:

1. The target company is a service-based business (or a knowledge-based business)—and not a capital-intensive business.
2. The selling shareholder/employee has identifiable technical expertise (such as proprietary knowledge of process designs, product recipes or formulas, or other trade secrets).
3. The selling shareholder/employee has personal relationships with suppliers, vendors, subcontractors, bankers, or other providers of goods and services to the target company.
4. The selling shareholder/employee has personal relationships with key employees of and/or consultants to the target company.
5. The selling shareholder/employee has personal relationships with customers, clients, patients, distributors, dealers, franchisees, and so forth.
6. The selling shareholder/employee is well known in the industry or profession for having unique experience, expertise, prominence, or eminence.

In assessing the fair market value of the seller's noncompete agreement, the Service typically also considers the legal enforceability of the contract. Such legal enforceability is often an issue of state-specific contract law and employment law statutes and/or judicial precedent.

These state-specific contract law issues may include the following factors:

1. The term of the agreement—depending on the state and the industry or profession, courts generally consider two- to three-year terms to be reasonable.
2. The scope of the agreement—which generally considers the extent of the restrictions on the seller's ability to earn a living.
3. The geographic area covered by the agreement—which generally considers whether the seller's noncompetition territory is local, regional, or national.

The Double Taxation in the Sale of C Corporation Shareholders

If the target company is a C corporation and the transaction is structured as an asset sale (or a stock sale followed by a Section 338 election), then the selling shareholders may be subject to double taxation on the gain related to the sale.

First, the target company itself will recognize a taxable gain on the sale of its assets to the acquirer (to the extent that the sale price exceeds the target company's asset tax basis).

Second, the selling shareholders are also subject to taxation when the target company distributes the remaining (after-tax) sale proceeds to the shareholders. That is, the selling shareholders are subject to tax on the gain related to the target company's distribution of the transaction sale proceeds.

For this reason, the selling shareholders in such a transaction may have an economic incentive to overstate the portion of the total transaction consideration allocated to any noncompete agreements. The payments for the noncompete agreements are only taxed once to the selling shareholders.

In addition, the selling shareholders have an economic incentive to overstate the portion of the total transaction consideration allocated to any intangible assets that are personally owned by those selling shareholders.

For example, in a private company sale transaction, the selling shareholders may personally own trade secrets, customer/client relationships, or personal goodwill. The acquirer's payments for these personally owned intangible assets is only taxed once to the selling shareholders.

Whether these intangible assets are target-company-owned or selling-shareholder-owned, they are Section 197 intangible assets to the acquirer.

Regardless of who the seller is, the acquirer will amortize the fair market value of the acquired intangible assets over the Section 197 15-year period.

For example, in the decision in *Norwalk v. Commissioner*,[2] the Tax Court concluded that the goodwill purchased in the business acquisition was the seller's personal goodwill—and not the target company's institutional goodwill. In that case, the acquirer did not obtain noncompete agreements with the selling shareholder/employees.

Based on the specific facts of that case, the Tax Court opined that there was acquired goodwill—in the form of valuable client relationships. However, the valuable goodwill was an intangible asset that was owned personally by the selling shareholder. The goodwill was not an intangible asset that was owned by the target company.

Therefore, that part of the transaction consideration was only subject to one level of taxation—to the selling shareholders (and not to the target company).

The point is that the double taxation related to certain private company sale transactions can be avoided. Such avoidance would occur if the sellers can demonstrate that they personally own—and control—valuable intangible assets. In the typical private company sale transaction, that valuable intangible asset is the sellers' personal goodwill.

Typically, the selling shareholder/employees will have a zero tax basis in the self-created personal goodwill. Therefore, the entire amount of the transaction consideration will be taxable gain to the sellers.

However, the personal goodwill should be a Section 1231 capital asset. Therefore, the amount of the transaction purchase price allocated to the personal goodwill should be only taxed once—at a long-term capital gain tax rate.

Depending on the sellers' level of taxable income, that capital gain tax rate may be 15 percent or 20 percent.

Purchase Price Allocation to Personal Intangible Assets

The Service may likely examine any M&A transaction when a large portion of the transaction consideration is allocated to the seller's personal goodwill.

In most private company purchase price allocations, the Service expects to see a large portion of the transaction consideration to be allocated to the target company's institutional goodwill.

When a material amount of seller personal goodwill is transferred in a target company purchase transaction, the transaction participants should obtain both legal advice and valuation analyst advice.

Legal counsel typically analyze the ownership of the transferred intangible assets. And, legal counsel typically ensure that all of the transaction documents are properly prepared so as to document which parties are transferring which intangible assets.

The valuation analyst typically identifies which intangible assets exist with respect to the business acquisition transfer, and the valuation analyst typically identifies all of the economic attributes related to each transferred intangible asset.

Based on the identification and assessment of these economic attributes, the valuation analyst typically estimates the fair market value of each transferred intangible asset. This intangible asset valuation analysis may be used for both (1) the seller's sale price allocation and (2) the acquirer's purchase price allocation.

As a legal consideration, counsel may document that the seller-owned intangible assets were not previously sold, contributed, or otherwise transferred to the target company. If the sellers are shareholder/employees, then the counsel typically reviews any employment agreements, shareholder agreements, or existing noncompete agreements.

The counsel may consider whether such agreements previously transferred the ownership of any existing or created intangible assets from the employees to the employer target company.

In particular, the counsel often drafts two separate asset and/or stock purchase agreements:

1. One agreement related to the transfer of any personally owned intangible assets
2. One agreement related to the transfer of any corporate-owned intangible assets

If there is only one set of asset purchase or stock purchase transaction documents, then counsel typically ensures that there are separate conceptual provisions related to:

1. the transfer of any personally owned intangible assets and
2. the transfer of any corporate-owned intangible assets.

In the decision in *Martin Ice Cream Company v. Commissioner*,[3] the Tax Court concluded that the customer relationships intangible asset transferred in the business acquisition had been personally owned by the shareholder/employee. The customer relationships intangible asset was not an asset owned or controlled by the target company.

In reaching this conclusion in the *Martin* case, the Tax Court emphasized two issues:

1. The selling shareholder/employee did not have either an employee agreement or an existing noncompete agreement with the target company.
2. The customer relationship intangible asset had never been transferred to the target company.

In the *Martin* decision, the Tax Court concluded that the target company did own other intangible assets that were also transferred in the business acquisition. Specifically, the Tax Court recognized that the target company owned the following intangible assets:

1. Distribution rights
2. Corporate books and records

However, the court did not assign a significant amount of value to these corporate-owned intangible assets.

In the *Martin* case, the sale of the customer relationships intangible asset personally from the selling stockholder to the corporate acquirer avoided the double taxation on that portion of the total transaction proceeds.

In addition, the sale of the personally owned intangible asset to the corporate acquirer was taxed to the selling shareholder at a lower capital gain tax rate.

Consulting Agreements versus Noncompete Agreements

As an alternative structure to asking the sellers to enter into noncompete agreements, the acquirer may consider asking the sellers to enter into consulting agreements. This alternative structure is particularly relevant if the selling shareholders will not remain as employees of the target company post transaction.

Obviously, the selling shareholders cannot be employees of—and consultants to—the acquired target company at the same time.

The payments made by the acquirer to the seller consultants are deductible to the buyer over the term of the consulting agreement. In other words, the consulting agreement payments are deductible to the buyer when the payments are made to the seller consultants—and not over a 15-year amortization period (as would be the case with noncompete agreement payments).

Accordingly, the acquirer gets a much faster tax recovery on the fair market value of consulting agreements than on any fair market value assigned in the transaction to noncompete agreements.

To the selling shareholders, both the payments received from a noncompete agreement and the payments received from a consulting agreement are considered to be ordinary income.

The only difference (and the only downside to the sellers) is that the consulting agreement payments are subject to employment taxes. That is, the consulting agreement payments are subject to FICA and other employment taxes.

In many cases, the sellers may already earn wages or self-employment income that would put them above the FICA and other employment tax withholding limitations. In such instances, these sellers would not be subject to such additional employment-related taxes.

However, the consulting payments will likely be subject to the 2.99 percent Medicare Health Insurance portion of self-employment taxes. In addition, the consulting payments may be subject to the additional 0.9 percent Medicare tax on earned income.

However, the acquirer and the sellers may be able to negotiate a compromise with respect to such employment-related taxes. That is, there is a material present value benefit to the acquirer to deduct the consulting payments immediately—compared to deducting the noncompete payments over 15 years.

This present value economic benefit may be large enough to encourage the acquirer to "make whole" the sellers with regard to the additional payroll taxes related to the consulting agreement (versus the noncompete agreement) payments.

Of course, in such consulting agreement arrangements, the sellers should be expected to occasionally consult with the acquirer with respect to the target company. The Service may scrutinize such a consulting agreement arrangement.

If the selling shareholders do not actually "consult," then the Service may recharacterize the consulting agreement payments as (15-year amortization) noncompete agreement payments.

Summary and Conclusion

Corporate acquirers typically expect that the sellers will enter into noncompete agreements with respect to the target company.

This transaction structuring observation is true whether the seller is a parent corporation or an individual selling shareholder. But, this transaction structuring observation is particularly true when the target company is a private company and the sellers are shareholder/employees.

There are tax considerations to both the acquirer and to the sellers with regard to how the target company sale transaction is structured. In particular, there are tax considerations to both the acquirer and to the sellers with regard to what portion of the total transaction consideration is allocated to any noncompete agreements.

Although much of this discussion applies to all target company acquisitions, this discussion focused on the type of transaction where the target company is a private C corporation and the sellers are shareholder/employees.

In order to maximize the tax benefits to all parties to the M&A transaction, all parties to the business transfer should consult with both legal counsel and valuation analysts.

The legal counsel typically reviews the structure of any noncompete agreements and other transaction agreements. And, the counsel will review the structure of any noncompete agreements and any other transaction agreements.

In addition, the counsel typically reviews the ownership of any seller personally owned intangible assets that are transferred in the target company acquisition.

The valuation analyst typically documents the economic attributes of the noncompete agreements and of any other intangible assets transferred in the target company acquisition. In addition, the analyst typically develops a supportable and credible fair market value valuation of the noncompete agreements and any other intangible assets.

The sellers may rely on such an intangible asset valuation for transaction sale price allocation purposes. And, the acquirer may rely upon such an intangible asset valuation for transaction purchase price allocation purposes.

Notes:

1. Recovery Group, Inc. v. Commissioner, 652 F.3d 122 (1st Cir. 2011).
2. Norwalk v. Commissioner T.C. Memo. 1998-279 (July 30, 1998).
3. Martin Ice Cream v. Commissioner, 110 T.C. 189 (1998).

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Best Practices for Property Appraisals within a Bankruptcy Context

Robert F. Reilly, CPA

This discussion considers the reasons why an appraiser may be asked to develop a debtor entity property appraisal within the context of a bankruptcy proceeding. For purposes of this discussion, the term property includes (1) real estate and real property, (2) tangible personal property, and (3) intangible personal property. This discussion focuses on defining the scope of the bankruptcy-related property appraisal. And, this discussion also considers best practices with regard to the development of—and the reporting of—the bankruptcy-related property appraisal.

Introduction

There are many reasons why an appraiser may be asked to value debtor entity property within a bankruptcy environment. While the focus of this discussion is on property appraisal, there are also many reasons why an appraiser may be asked to develop a property damages analysis or transfer price analysis within a bankruptcy environment.

Before the appraiser is retained, the party-in-interest to the bankruptcy (and, typically, the party's counsel) should carefully define the property appraisal assignment. Based on that assignment definition, the appraiser, the client, and counsel can all agree on the objectives and the scope of the property appraisal.

This discussion summarizes the generally accepted property appraisal approaches and methods that appraisers typically consider in a bankruptcy-related assignment. This discussion also describes the property appraisal synthesis and conclusion process.

Due to the litigious nature of a bankruptcy proceeding, bankruptcy-related property appraisals are often subject to a rigorous contrarian review. Therefore, this discussion recommends best practices related to the attributes of an effective (i.e., persuasive) bankruptcy-related property appraisal report.

A Property Appraisal

First, let's define the term "property" within the context of this discussion. Second, let's define the term "appraisal" within the context of this discussion.

For purposes of this discussion, let's define the term "property" within a bankruptcy context. Unfortunately, the U.S. Bankruptcy Code does not define either the term "property" or the term "asset."

For purposes of this discussion, "property" is a legal term and "asset" is an accounting term. In general conversation, even in appraisal-related conversation, these two terms are treated as synonyms. However, they do not mean exactly the same thing. Not all types of property are considered to be assets. And, not all types of assets are considered to be property.

Black's Law Dictionary defines property as:

1. Collectively, the rights in a valued resource such as land, chattel, or an intangible. It is common to describe property as a "bundle of rights." These rights include the rights to possess and use, the right to exclude, and the right to transfer.
2. Any external thing over which the rights of possession, use, and enjoyment are exercised.[1]

So, typically, in order for something to be considered property, there should be an identified bundle of legal rights (including the legal right to transfer) associated with it.

While the term property has a legal definition, the term assets has an accounting definition. The term assets is generally defined by reference to the Financial Accounting Standards Board Statement of Concepts No. 8, *Conceptual Concepts for Financial Reporting* ("CON8").

According to CON8, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." CON8 also states, "An asset is a present right of an entity to an economic benefit." And, CON8 continues as follows:

> An asset has the following two essential characteristics:
>
> (a) It is a present right.
>
> (b) The right is to an economic benefit.

Both the legal definition of property and the accounting definition of assets focus on the concept of a bundle of rights. The result of something being considered to be property is that the property rights can be legally protected. The result of something being considered to be an asset is that it is recognized on an entity's balance sheet prepared in accordance with U.S. generally accepted accounting principles ("GAAP").

However, not all legally protected property is recognized on a GAAP balance sheet. And, not all assets recorded on a GAAP balance sheet are legally protected property.

This discussion focuses on the concept of property within a bankruptcy context. However, this discussion recognizes that (rightly or wrongly) the term assets is frequently referred to within the bankruptcy context.

This discussion will adopt the definition of "appraisal" provided in the *Uniform Standards of Professional Appraisal Practice* ("USPAP"). USPAP defines appraisal as, "(noun) the act or process of developing an opinion of value; an opinion of value; (adjective) of or pertaining to appraising and related functions such as appraisal practice or appraisal services."[2]

This USPAP definition of the term "appraisal" is applicable to most bankruptcy-related issues. Unfortunately, the U.S. Bankruptcy Code does not provide a definition of value—or of any particular standard of value. In other words, the Bankruptcy Code does not define fair value, fair market value, market value, or any other standard (or definition) of value. And, the Bankruptcy Code does not inform us as to which standard of value is relevant to which type of bankruptcy question.

Types of Property

This discussion is generally applicable to most categories of debtor entity property that may become an issue in a bankruptcy proceeding. Specifically, this discussion generally encompasses the following categories of debtor entity property:

1. Real estate and real property
2. Tangible personal property
3. Intangible personal property

For purposes of this discussion, the real estate property category includes the tangible elements of land and the structures affixed to land, including, for example, the following:

1. Land
2. Land improvements
3. Buildings and building components

For purposes of this discussion, the real property category includes the intangible elements of real estate, including, for example, the following:

1. Lessor and lessee interests
2. Easements and rights of way
3. Air, water, and subsurface rights

For purposes of this discussion, tangible personal property includes, for example, the following property categories:

1. Office furniture and fixtures
2. Manufacturing machinery and equipment
3. Processing machinery and equipment
4. Trucks and automobiles
5. Computers and information technology equipment

For purposes of this discussion, intangible personal property includes, for example, the following property categories:

1. Identifiable intangible assets
2. Intellectual property
3. Personal and institutional (business) goodwill

We note that the U.S. Bankruptcy Code does not include trademarks or trade names within its definition of intellectual property. However, for purposes of this discussion, the term intellectual property is intended to include all of the following categories: trademarks and trade names, patents, copyrights, and trade secrets.

Unless specifically noted, most of the following discussion will apply to each of the above-listed categories of debtor entity property.

The Bankruptcy Valuation Assignment

A statement of the purpose and the objective of the appraisal is a best practice at the outset of any bankruptcy-related valuation assignment.

Such a statement requires the appraiser, the client, and legal counsel to carefully think through all of the so-called elements of the valuation assignment. Such a statement also mitigates the possibility of any misunderstandings about the bankruptcy-related valuation assignment.

Whether tangible property or intangible property is the subject of the appraisal, it is a best practice to consider all of the elements of the assignment. When parties need to know the value of property that is either owned by or operated by a debtor entity, the party-in-interest to the bankruptcy should carefully define the elements of the valuation.

Bankruptcy law seeks to preserve the ongoing value of—and to maximize the economic stake of—the creditors to the debtor entity. Typically, in the bankruptcy environment, contracts, leases, and licenses can be assumed, rejected, or assigned. This fact may complicate the appraisal when the debtor in possession ("DIP") is either a property lessor/licensor or a property lessee/licensee.

For example, let's assume that the debtor entity is an intellectual property licensor and that the license may be assignable by the bankruptcy estate to the licensor's competitor. In that case, the appraiser may have to consider whether the intangible property appraisal should be based on the expectation that the licensor is required to continue to support (e.g., make improvements to) the intellectual property (even if it is in the hands of a competitor).

Defining the assignment is a first best practice in the property appraisal process. This definition may influence many of the appraiser's considerations and procedures. The assignment definition may influence many of the decisions to be made in the appraisal. The time spent by the appraiser, the client, and legal counsel to define the purpose and the objective of the valuation assignment is time well spent.

There are many possible clients for a bankruptcy-related appraisal assignment. This is because there are typically many parties-in-interest to a commercial bankruptcy. These various parties may include the debtor entity, the debtor entity directors, the court-appointed bankruptcy trustee, the individual secured creditors, a secured creditors committee, an unsecured creditors committee, the individual contract counterparties (e.g., a labor union), and the debtor entity equity holders.

Each of these parties may have an interest in some valuation (or damages or transfer price) aspect of the bankruptcy proceeding.

Regardless of who the client is, the valuation assignment is typically provided by the client to the appraiser. The valuation assignment should describe the objective of the appraisal by considering these elements of the appraisal:

1. Definition of the subject property
2. Description of the ownership characteristics subject to appraisal
3. Decision of the appropriate bundle of legal rights
4. Decision of the appropriate standard of value
5. Decision of the appropriate premise of value
6. Specification of the "as of" valuation date

Before these elements are defined, the purpose of the valuation assignment should be agreed to. That is, the elements of the valuation assignment may also be influenced by the stated purpose of the appraisal. The purpose of the valuation assignment should describe the following:

1. Why the property appraisal is being prepared
2. Why the appraisal is being prepared
3. Who may (and may not) rely on the property value conclusions

The Bankruptcy Valuation Purpose

There are many reasons why an appraiser may be asked to value the debtor entity property within a bankruptcy context. For this purpose, the subject property can include both:

1. the property owned by the debtor entity and
2. the property operated by the debtor entity (including inbound and outbound leases and licenses).

The property could serve as collateral for either the debtor entity's pre-bankruptcy financing or the DIP financing. A debtor property sale or license could serve to generate needed cash flow for the financially troubled DIP.

The appraiser may be asked to opine on the fairness of the consideration or terms of a property sale, lease, or license. The appraiser may be asked to opine on the impact of an assignment or a rejection of a lease or a license. The appraiser may assess this transactional fairness to the creditors or to other parties-in-interest.

The property value often affects the debtor entity solvency (or insolvency) at various dates prior to the bankruptcy filing.

These debtor entity solvency issues become relevant with regard to allegations of fraudulent conveyance or preference payments. Such solvency issues also may be relevant when the pre-filing debtor entity is operating within the so-called zone of insolvency.

The debtor entity property commercialization potential (or the associated spin-off opportunities) could affect the reasonableness of a proposed plan of reorganization. And, the fair value of the property may be recognized in the fresh start accounting when the debtor entity emerges from bankruptcy.

Under GAAP, the fresh start accounting fair value measurement guidance is provided in the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 852.

Counsel is often involved in the bankruptcy-related property appraisal. This is because counsel is involved in assisting the party-in-interest client in structuring transactions, complying with taxation and accounting requirements, negotiating and arranging financings, litigating claims, and defending and commercializing the debtor entity property.

Within a bankruptcy context, counsel may become involved in the process of:

1. identifying the debtor entity property;
2. performing the related due diligence procedures;
3. interviewing and selecting the appropriate appraiser;
4. defining the appraiser's assignment;
5. helping to assemble valuation-related data and documents;
6. providing legal instructions to the appraiser;
7. reviewing and challenging the property appraisal work product;
8. interpreting and relying on the property appraisal report; and
9. defending the appraiser—and the value conclusions—during any administrative, regulatory, or judicial proceeding.

The appraiser may value the debtor entity property in a bankruptcy proceeding without legal advice from, or assistance by, counsel. However, due to the special nature of the bankruptcy-related engagement, the appraiser and counsel will often work closely in several phases of the bankruptcy-related appraisal.

The following list summarizes some of the many reasons why an appraiser may be asked to value debtor entity property in a bankruptcy environment. Such assignments may come directly from a party-in-interest to the bankruptcy. However, such assignments may also come from counsel to one of the parties.

1. Transaction pricing and structuring
   - Pricing the sale of a DIP's individual property or of a portfolio of two or more property assets
   - Pricing the license of the DIP's individual property or of a portfolio of two or more property assets
   - Valuing the equity allocations in a DIP joint venture when one or more parties contributes property
   - Valuing the asset distributions in a debtor entity liquidation when one or more parties receives distributed property assets
   - Transferring a property between a parent company's subsidiaries (when one subsidiary has filed for bankruptcy protection and another subsidiary has not filed for bankruptcy protection)
2. Financings collateralization and securitization
   - Use of the property as collateral for cash-flow-based or asset-based pre-bankruptcy debt financings
   - Sale/leaseback financing of the (pre-bankruptcy) debtor entity property
3. Taxation planning and compliance

- Effect of the property value on the Internal Revenue Code Section 382 limitation on the debtor entity's use of a net operating loss
- Effect of the property value on the Section 108 discharge of indebtedness income exclusion related to the debtor entity amount of insolvency

4. Adequate consideration for DIP transactions
   - Use of debtor entity property as collateral for a secured creditor's position
   - Use of debtor entity property as collateral for a new secured financing for the DIP
   - Fairness of the sale or lease of property as a DIP cash generation spin-off opportunity
   - Use of the property in the assessment of the debtor entity's solvency or insolvency with respect to alleged fraudulent transfers and preference actions
   - Impact of the debtor entity property on the reasonableness of a proposed plan of reorganization
5. Financial accounting and fair value measurement
   - Fair value measurement impairment testing of debtor entity tangible property, intangible property, and goodwill
   - Post-bankruptcy fresh start accounting for the tangible assets and intangible assets of the reorganized debtor entity emerging from bankruptcy
6. Debtor entity strategic planning and management information
   - Formation of a DIP property joint venture, joint development agreement, or joint commercialization agreement
   - Negotiation of a DIP inbound or outbound property use, development, commercialization, or exploitation agreement, lease, or license
   - Identification and negotiation of a DIP property license, spin-off, joint venture, and other commercialization opportunity
7. Other bankruptcy considerations
   - Prosecution or defense of secured creditor claims that the debtor entity property collateral had "inconsequential value"
   - Assessment of the impact on the DIP's decision to reject property inbound/outbound lease or license agreements
   - Assessment of the impact on a counterparty of the DIP's decision to reject property inbound/outbound lease or license agreements

Defining the purpose of the assignment may influence the form or the format of the property appraisal work product. The appraisal report can be oral, written, or a combination of the two. The appraisal report should be prepared for a specified purpose and for a specified audience.

The property appraisal should consider all of the appraisal approaches and methods that are relevant for the intended audience. And, the appraisal report should include all of the information appropriate to the intended audience.

The assignment should describe the purpose of the appraisal. And, that assignment purpose should consider the following elements of the appraisal:

1. How will the property appraisal be used?
2. Who will rely on (or receive a copy of) the appraisal report?
3. What form and format of appraisal report is appropriate?
4. Are there any legal instructions (e.g., specific statutory definitions, judicial precedent, or reporting requirements) that the appraiser should consider?

In addition to understanding the reason for developing the property appraisal, it is a best practice for the appraiser to understand exactly what the appraisal objective is. The client or counsel should specifically define which of the following opinions the appraiser is being asked to render:

1. Estimate a value (as specifically defined) for the debtor entity property
2. Measure lost profits or some other damages measurement related to a tort or breach of contract related to the debtor entity property
3. Conclude an arm's-length price for the intercompany transfer of the property
4. Estimate a fair lease or license agreement royalty rate between independent arm's-length parties
5. Conclude the fairness of a property, sale, lease, license, or other transfer transaction from a financial perspective

6. Estimate the debtor entity property useful economic life ("UEL")

The Bankruptcy Appraisal Objective

The first element of the appraisal objective is a definition of the debtor entity property. That definition should specify exactly what property is the subject of the appraisal.

This definition should describe all of the tangible property and intangible property that are included as the subject of the appraisal.

In a bankruptcy-related environment, there may be uncertainty—or controversy—as to exactly what bundle of property—and property rights—should be included with (or excluded from) the assemblage of property that is the objective of the appraisal.

For example, in the property appraisal, there may also be controversy as to whether to include future access to the assets that are not in place as of the valuation date.

The second element of the appraisal objective is a description of the ownership characteristics of the property rights, including any lease, license, or contract in effect.

When a debtor entity operates within the so-called zone of insolvency, that condition may undermine the incentives for the debtor to (1) lease or license any property and (2) make investments to exploit any lease or license agreements that have already been entered into.

When a bankruptcy petition is filed and the bankruptcy stay has been entered, the debtor (as property licensor/leasor or licensee/lessee) cannot pursue a breach of contract action without authorization from the bankruptcy court.

If there is a lease, license, or other agreement associated with the debtor's property, then the appraiser should be made aware of all relevant contract terms, such as the following:

1. Licensor/licensee responsibility contract terms
   - Legal protection requirements
   - Maintenance expenditures
   - Development expenditures
   - Licenses, permits, or other regulatory approvals
2. Other contract terms
   - Minimum use, production, or sales
   - Minimum marketing or commercialization expense
   - Property development payments, completion payments
   - Party responsible to obtain the required approvals
   - Milestone lease or license payments

The third element of the appraisal objective is a description of the bundle of legal rights. The assignment should specify which of the following (or which other) bundles of rights should be included in the appraisal:

1. Fee simple interest
2. Term/reversion interest
3. Licensor/licensee interest
4. Lessor/lessee interest
5. Territory (domestic/international) interest
6. Product line/industry interest
7. Sublease or sublicense rights
8. Development rights
9. Commercialization/exploitation rights

The fourth element of the appraisal objective is the standard (or the definition) of value. The standard of value typically relates to the question: Value to whom? Different standards of value often correspond to different reasons to conduct the appraisal.

The standard of value may be determined by a statutory, judicial, regulatory, or administrative requirement. Therefore, the client (or counsel) should instruct the appraiser as to the appropriate standard of value.

Some of the alternative standards of value that may be concluded in a debtor entity property appraisal include the following:

1. Fair value
2. Fair market value
3. Market value
4. Use value
5. User value
6. Owner value
7. Investment value
8. Acquisition value

The fifth element of the appraisal objective is the premise of value. The premise of value considers the assumed set of transactional circumstances under which the property transfer (i.e., sale or license) will take place.

Some of the alternative premises of value that may be applied in a debtor entity property appraisal include the following:

1. Value in continued use
2. Value in place (but not in use)
3. Value in exchange—orderly disposition basis
4. Value in exchange—voluntary liquidation basis
5. Value in exchange—involuntary liquidation basis

The selected premise of value is typically an assignment instruction from the client (or counsel) to the appraiser. If the client (or counsel) does not instruct the appraiser as to the appropriate premise of value, then the appraiser may select the premise of value that concludes the highest and best use ("HABU") for the debtor entity property.

The tests for HABU are based on an analysis of what is physically possible, legally permissible, and financially feasible with regard to the subject property.

In selecting the appropriate HABU of the subject property, the appraiser may consider the following alternatives:

1. Current owner/operator HABU
2. New owner/operator (marketplace) HABU
3. Licensor/lessor and licensee/lessee HABU

The sixth element of the appraisal objective is the valuation date. The client (or counsel) will instruct the appraiser as to the appropriate "as of" date on which to conclude the defined value.

The date, or dates, as of which the property is valued may be important to the value conclusion. This is because circumstances can cause values to vary materially from one date to another, and the valuation date directly influences data available for the appraisal.

Many internal and external factors can influence property value. A sudden change in the debtor entity earnings, especially if unanticipated, can have a material effect on value. Also, the property value can vary with the debtor entity's cost of capital, a factor that can vary over time. Major events, such as the signing or the termination of a license agreement, can also affect the property value.

In order to serve the information needs of the client, the appraiser should have a clear understanding of the assignment. In a bankruptcy-related assignment, counsel is typically responsible for ensuring that the appraiser develops that understanding.

Appraisal Data Gathering and Due Diligence Procedures

Before selecting and applying any of the generally accepted property appraisal approaches, methods, and procedures, the appraiser performs due diligence with respect to the debtor entity property.

Counsel may participate in this due diligence process. That counsel participation may particularly occur if the appraisal relates to a property transaction, financing, or litigation.

These due diligence procedures relate to identifying and obtaining information for the property appraisal. The appraiser's due diligence process is a supplement to—and not a substitute for—counsel's legal due diligence process.

First, the appraiser typically gathers and analyzes information related to the current owner/operator (i.e., the debtor entity). The information typically relates to the property's historical development and current use.

Such information may include the following:

1. Owner/operator historical and prospective financial statements
2. Owner/operator historical and prospective development/maintenance costs
3. Current and expected owner/operator resource/capacity constraints
4. Description and estimate of the property's economic benefits to the current owner/operator
   - Associated revenue increase (e.g., related product unit price/volume, market size/position)
   - Associated expense decrease (e.g., expense related to product returns, cost of goods sold; selling, general, and administrative, R&D)
   - Associated investment decrease (e.g., inventory, capital expenditures)
   - Associated risk decrease (e.g., the existence of a property lease, license, or other contract, decrease in the cost of capital components)

The appraiser may consider the property's market potential outside of the debtor entity. For example, the appraiser may consider the following factors from the perspective of an alternative (e.g., hypothetical willing buyer/willing lessee or licensee) owner/operator:

1. Change in the market definition or in the market size for an alternative owner/user

2. Change in alternative/competitive uses for an alternative owner/user
3. The property's ability to create inbound/outbound lease or license opportunities to an alternative owner/user
4. Whether the debtor entity can operate the property and also outbound lease or license the property (in different products, different markets, different territories, etc.)

The appraiser may also review and challenge any debtor-prepared financial projections and any debtor-prepared measurements of property's economic benefits. The appraiser may test such financial projections and economic benefit measurements against industry, guideline company, and other benchmark comparisons.

For example, the appraiser may perform the following comparative benchmark analyses:

1. Compare prior debtor entity projections to prior debtor actual results of operations
2. Compare current debtor management projections to the debtor's current capacity constraints
3. Compare current debtor management projections to the current total market size
4. Consider published industry average comparable profit margin data
5. Consider selected guideline publicly traded company profit margin data
6. Consider the quality and the quantity of available guideline or comparable property lease or license data
7. Perform a debtor property UEL analysis, with consideration to the following:
   - Physical life
   - Legal/statutory life
   - Contract/license life
   - Technology obsolescence life
   - Economic obsolescence life
   - Lives (i.e., ages) of any prior generations of the subject property
   - Position of the subject property in its life cycle

In addition to comparing the debtor entity's historical and projected results of operations to those of selected guideline public companies (described below), the appraiser may compare the debtor entity results of operations to published industry data sources.

Generally Accepted Property Appraisal Approaches and Methods

The three generally accepted property appraisal approaches are the cost approach, the market approach, and the income approach. These appraisal approaches apply generally to real estate, to tangible personal property, and to intangible personal property.

Appraisers typically consider, and attempt to apply, all three generally accepted property appraisal approaches in each debtor entity property appraisal. Practically, however, many industrial or commercial property appraisals are based primarily on the application of one or two of the property appraisal approaches.

For each property appraisal, the appraiser selects the generally accepted approach (or approaches):

1. for which there is the greatest quantity and quality of available data,
2. for which the appraiser can perform the most comprehensive due diligence procedures,
3. that best reflect the actual transactional negotiations of market participants in that industry,
4. that best fit the characteristics (e.g., use, age, etc.) of the debtor entity property, and
5. that are most consistent with the professional experience and informed judgment of the appraiser.

Within each property appraisal approach, there are several appraisal methods that the appraiser can select and apply. And, within each method, there are numerous appraisal procedures that the appraiser can perform. Appraisal procedures are performed within a method to conclude a value indication. The appraiser may perform two or three appraisal methods within a single appraisal approach.

For example, the appraiser may develop two different income approach methods and reconcile the three value indications in order to conclude a single income approach value indication.

The appraiser reconciles the various value indications (if more than one approach is used). This synthesis of the various value indications results in a final value conclusion for the debtor entity property.

All of the cost approach appraisal methods are based on the principle of substitution. That is, the

value of the actual property is influenced by the cost to create a substitute property.

All cost approach appraisal methods apply a comprehensive definition of cost, including consideration of an opportunity cost component during the property development stage. In addition, the cost of the substitute property should be reduced (or depreciated) in order to make the substitute property comparable to the actual property.

All market approach appraisal methods are based on the principles of (1) efficient markets and (2) supply and demand. That is, the value of the debtor entity property may be estimated by reference to prices paid in the marketplace for the arm's-length sale, lease, or license of comparable (or guideline) property. Comparable sale data are analyzed in order to extract pricing multiples or other metrics that can be applied to the debtor entity property.

All income approach appraisal methods are based on the principle of anticipation. That is, the value of any income-producing property is the present value of the income that the owner/operator expects to receive from owning or operating that property. All income approach methods involve a projection of some measure of owner/operator income over the property's expected UEL.

Such income measures may relate to:

1. the income earned from operating the property in the owner/operator business enterprise and/or
2. the income earned from leasing or licensing the property from the owner/licensor to an operator lessor/license that will pay a lease payment or a royalty (or some other fee) for the use of the property.

This income projection is converted to a present value by the use of a risk-adjusted present value discount rate (or an annuity direct capitalization rate).

Cost approach appraisal methods may be particularly applicable to the valuation of a recently developed debtor entity property. In the case of relatively new property, the debtor entity development cost and effort development data may be available (or may be subject to accurate estimation).

In addition, cost approach appraisal methods may be applicable to the appraisal of in-process property, special purpose property, or noncommercialized property.

In all cases, the appraiser should realize that the debtor entity property value is not derived from the cost measure alone. Rather, the property value is derived from the cost measure (however defined) less appropriate allowances for all forms of depreciation and obsolescence.

Market approach methods may be applicable when there is a sufficient quantity of comparable (almost identical) or guideline (similar from an investment risk and expected return perspective) property transaction data. These transactions may relate to either sale, lease, or license transactions.

The appraiser attempts to extract market-derived valuation pricing indications (e.g., pricing multiples or other metrics) from these comparable transaction data to apply to the corresponding metrics of the subject property.

Income approach appraisal methods may be applicable in situations where the debtor entity property is used to generate a measurable amount of income. This income can either be:

1. operating income (when the property is used in the owner's business operations) or
2. ownership income (when the property is leased or licensed from the owner/licensor to an operator/licensee) to produce rental or royalty income.

Income approach appraisal methods may be applied when the owner/operator has elected to not currently commercialize the property. An example may be when this forbearance of use is for the purpose of protecting the income that is produced by the owner/operator's other property.

For Further Reference

The following discussion summarizes the generally accepted property appraisal approaches and methods. This discussion is intended to be general and apply to all debtor entity property categories. There are both professional literature and valuation professional organization ("VPO") professional standards related to the appraisal of the individual categories of debtor entity property.

For example, for a more comprehensive discussion of real estate appraisal approaches, methods, and procedures, readers are referred to *The Appraisal of Real Estate*, 15th edition, published by the Appraisal Institute in 2020.

For a more comprehensive discussion of tangible personal property appraisal approaches, methods, and procedures, readers are referred to *Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets*, 4th edition, published by the American Society of Appraisers in 2020.

And, for a more comprehensive discussion of intangible personal property appraisal approaches, methods, and procedures, readers are referred to *Guide to Intangible Asset Valuation*, revised edition, published by the American Institute of Certified Public Accountants in 2014.

Cost Approach Appraisal Methods

There are several generally accepted property appraisal methods within the cost approach. Each of the appraisal methods applies a particular definition of cost.

These definitions of cost include the following:

1. Reproduction cost new ("RPCN")
2. Replacement cost new ("RCN")
3. Historical cost (or original cost) ("HC" or "OC")

RPCN is the total cost, at current prices, to develop an exact duplicate of the actual property. RCN is the total cost, at current prices, to develop an asset having the same functionality or utility as the actual property.

Functionality is an engineering concept that means the ability of the property to perform the task for which it was designed. Utility is an economics concept that means the ability of the property to provide an equivalent amount of satisfaction.

Historical cost is less frequently applied in cost approach property appraisals. However, it is sometimes applied in the development of unit principle property appraisals developed for property tax purposes.

And historical cost is sometimes applied in the appraisal of public utility or other regulated-industry property. Historical cost considers the cost of the subject property when it was originally purchased, constructed, or developed.

In contrast, original cost considers the cost of the subject property when it was purchased, constructed, or developed by the current property owner. So, historical cost considers the price paid by the very first property owner—when the property was first placed in service. Original cost considers the price paid by the current owner to the previous property owner. In a business combination (e.g., a merger or acquisition transaction), the original cost may be influenced by the transaction purchase price allocation.

There are other cost definitions that may be applicable to a cost approach property appraisal. Some appraisers consider a measure of cost avoidance as a cost approach method. This appraisal method quantifies either historical or prospective costs that are avoided because the debtor entity actually owns (and does not have to lease or license) its own property.

Some appraisers consider historical cost or trended historical cost as a cost measure. In the trended historical cost method, historical development costs are identified and trended to the valuation date by an inflation-based index factor.

Regardless of the specific cost definition applied, all cost approach appraisal methods include a comprehensive definition of cost.

The cost measurement (whether RCN, RPCN, or some other cost measure) typically includes the following four cost components:

1. Direct costs (e.g., materials)
2. Indirect costs (e.g., engineering and design labor)
3. The property developer's profit (on the direct cost and indirect cost investment)
4. An opportunity cost/entrepreneurial incentive (to motivate the property development process)

The property construction or development material, labor, and overhead costs may be easy to identify and quantify. The developer's profit may be estimated using several procedures. It is often estimated as a percentage profit margin on the developer's investment in the material, labor, and overhead costs.

The entrepreneurial incentive may be measured as the lost profits during the replacement property development period. Alternatively, entrepreneurial incentive is sometimes measured as a fair rate of return on investment during the duration of the property development process.

For example, let's assume it would take two years to develop a replacement property. If the buyer buys the seller's actual property, then the buyer can start earning income (either operating or license income) immediately.

To illustrate entrepreneurial incentive, let's consider the development (or replacement) of a property. If the property buyer "builds" its own hypothetical replacement property, then the property buyer will not earn any income (operating or license) during the two-year development period.

The two years of lost profits during the hypothetical property development period represents the opportunity cost of developing a new replacement

property—compared to buying the debtor entity's actual property.

All four cost components—that is, direct costs, indirect costs, developer's profit, and entrepreneurial incentive (or opportunity cost)—should be considered in the cost approach analysis. While the cost approach is a different set of analyses from the income approach, there are economic analyses included in the cost approach.

These cost approach economic analyses provide indications of both:

1. the appropriate levels of opportunity cost (if any) and
2. the appropriate amount of economic obsolescence (if any).

The current cost metric (however measured) should be adjusted for losses in value due to:

1. physical deterioration,
2. functional obsolescence, and
3. external obsolescence.

Physical deterioration is the reduction in property due to physical wear and tear. While it is unlikely that an intangible property will experience physical deterioration, this type of appraisal depreciation should be considered in every property appraisal.

Functional obsolescence is the reduction in value due to the property's inability to perform the function (or yield the periodic utility) for which it was originally designed. The technological component of functional obsolescence is a decrease in value due to improvements in technology that make the actual property less than the ideal replacement for itself.

External obsolescence relates to a decrease in property value due to influences external to (or outside of) the subject property. The economic obsolescence component of external obsolescence is a reduction in value due to the effects, events, or conditions that are external to—and not controlled by—the property current use or condition.

The impact of economic obsolescence is typically beyond the control of the debtor entity.

In any cost approach analysis, the appraiser typically estimates the amounts (if any) of the property physical deterioration, functional obsolescence, and economic obsolescence. In this estimation, the appraiser typically considers the property's actual age—and its expected UEL.

Appraisers sometimes apply the following cost approach formula to quantify RCN: RPCN – curable functional obsolescence = RCN.

To estimate the debtor entity property value, analysts often apply the following cost approach formula: RCN – physical deterioration – economic obsolescence – incurable functional obsolescence = property value.

In summary, in the application of the cost approach to value debtor entity property within a bankruptcy context, the appraiser should recognize the following misconceptions regarding the cost approach:

1. The cost approach value indication does not equal accounting net book value (and the cost approach does not include the so-called net book value method).
2. The cost approach to property valuation is not the asset-based approach to business valuation.
3. The cost approach only considers future costs. That is, the cost approach considers the costs that would be measured on the valuation date to replace or reproduce the subject property. The cost approach is not a backward-looking analysis.
4. The so-called cost savings method is an income approach valuation method, not a cost approach valuation method.
5. The cost approach considers capitalizable expenditures, and not current period expenses.
6. The cost approach should consider an opportunity cost component (as part of the entrepreneurial incentive cost component).
7. The cost approach should consider all forms of obsolescence.
8. The cost approach does not typically consider any income tax considerations.

Market Approach Appraisal Methods

Appraisers often attempt to apply market approach methods first in the debtor entity property valuation process. This is because the market—that is, the economic environment where arm's-length transactions between unrelated market participants occur—often provides the best indicator of value.

However, the market approach will only provide meaningful appraisal pricing evidence when the actual (i.e., the debtor's) property is sufficiently similar to the guideline properties that are transacting (by sale, lease, or license) in the marketplace. In that case, the guideline transaction (sale or license)

prices may provide market-derived evidence of the expected price for the debtor entity's property.

The generally accepted market approach property appraisal methods include the following:

1. The comparable transaction (or comparable sales) method (principally applied to tangible property)
2. The relief from royalty method (principally applied to intangible property)

In the comparable transaction method, the appraiser searches for arm's-length sales, leases, or licenses of either comparable or guideline property.

In the relief from royalty ("RFR") method, the appraiser recognizes that the debtor entity in fact owns the subject intangible property. However, the appraiser assumes that, if the debtor entity did not own the intangible property, then the debtor would have to inbound license the use of that property from a third-party licensor.

Therefore, because the debtor does own the actual property, the debtor is "relieved" from having to pay a royalty payment on the inbound license of the property. The appraiser values the subject intangible property as the present value of the license royalty payment that the debtor entity is "relieved" from paying.

In the application of the comparable transaction method, the appraiser often relies on comparable or guideline sale transactions related to real estate or tangible personal property. This is because third-party sales of tangible property are more typical than third-party sales of intangible property.

In the comparable transaction method, first, the appraiser researches the appropriate exchange markets to obtain information about sale transactions, involving either guideline (i.e., similar from an investment risk and expected return perspective) or comparable (i.e., almost identical) property that may be compared to the debtor entity property.

Some of the comparison attributes may include characteristics such as property type, property use, industry in which the property operates, date of sale, and so on.

Second, the appraiser verifies the transactional information by confirming that (1) the transactional data are factually accurate and (2) the sale exchange transactions actually reflect arm's-length market considerations.

If the guideline sale or license transaction was not at arm's-length market conditions, then adjustments to the transactional data may be necessary.

This verification procedure may also elicit additional information about the current market conditions related to the potential sale of the actual debtor entity property.

Third, the appraiser typically selects relevant units of comparison (e.g., income pricing multiples or dollars per unit—such as "per horse power" or "per square foot"). And, the appraiser develops a comparative analysis for each selected unit of comparison.

Fourth, the appraiser compares the selected guideline or comparable property sale or license transactions with the debtor entity's actual property, using the selected elements of comparison.

Then, the appraiser adjusts the sale price of each guideline transaction for any differences between (1) the guideline property and (2) the actual property. If such comparative adjustments cannot be measured, then the appraiser may eliminate the sale transaction as a guideline for future valuation consideration.

Fifth, the appraiser selects pricing metrics to apply to the actual property from the range of pricing metrics indicated from the guideline or comparable transactions.

The appraiser may select pricing multiples at the low end, midpoint, or high end of the range of pricing metrics indicated by the transactional sale data. The appraiser selects the subject-specific pricing metrics based on the appraiser's comparison of the actual property to the guideline property.

Sixth, the appraiser applies the selected subject-specific pricing metrics to the debtor entity's financial or operational fundamentals (e.g., revenue, income, amount of motor horsepower, amount of building square feet, etc.). This procedure typically results in several market-derived value indications for the debtor entity's property.

Seventh, the appraiser reconciles the various value indications produced from the analysis of the guideline sale transactions into a single market approach value indication. In this final reconciliation procedure, the appraiser summarizes and reviews (1) the transactional data and (2) the quantitative analyses (i.e., various pricing multiples) that resulted in each value indication.

Finally, the appraiser resolves these multiple value indications into a single market approach value indication.

The appraiser may confer with the debtor entity management to explore whether the debtor itself has entered into any property sale agreements. These debtor entity agreements may relate to sale of operating property or surplus property—either before or during the bankruptcy proceedings.

The RFR method also relies on arm's-length transactional data—in this case, the inbound or outbound license of comparable or guideline intangible property. Some appraisers consider the RFR method to be an income approach valuation method. This is because a projected royalty expense savings is capitalized in order to reach a value indication.

Other appraisers consider the RFR method to be a cost approach appraisal method. This is because the "cost" of the royalty (i.e., the expense of the license payment) is avoided because rights associated with the intangible property is owned by the debtor owner/operator.

However, this intangible property valuation method is typically considered to be a market approach appraisal method. This is because the RFR method relies on market-derived, empirical transaction data.

In applying the RFR method, the appraiser assumes that the debtor entity does not own the actual intangible property. Without this ownership, the debtor entity would have to license the intangible property from a hypothetical licensor.

So the debtor entity becomes a hypothetical licensee that licenses the intangible property from a hypothetical third-party licensor. In that scenario, the debtor entity or licensee would have to pay a royalty payment to the hypothetical owner or licensor. The royalty payment would be for a use license to use the intangible property in the debtor's business operations.

In reality, the debtor entity does own the intangible property. Because of that ownership, the debtor entity avoids the cost of having to pay a use license royalty payment to a third-party licensor. Therefore, the debtor's intangible property can be valued by reference to this hypothetical royalty payment that the debtor is relieved from making.

The hypothetical royalty payment is often calculated as a market-derived royalty rate multiplied by the debtor entity's revenue. So the application of this method requires (1) an analysis of comparable property license royalty rates and (2) a projection of the debtor entity revenue related to the use of the actual intangible property.

In this appraisal method, the revenue expected to be generated by the intangible property (from all sources) during its UEL is multiplied by the selected royalty rate. The product of the multiplication is a projection of the royalty expense that the owner/operator is relieved from paying because of its ownership of that intangible property.

This projected royalty expense is capitalized over the intangible property's UEL. The result of this capitalization process is the intangible property value indication.

Although the projected royalty expense is typically based on a royalty rate multiplied by the debtor's entity's revenue, it could also be based on a royalty rate multiplied by gross profit, net income, number of units produced, number of units sold, or some other owner/operator metric.

The royalty expense should be the amount of the net royalty expense that the debtor entity is relieved from paying. Therefore, if the debtor entity would have to pay for intangible property development, maintenance, promotion, or legal protection expenses (as part of its licenses agreement), then these expenses should be subtracted from the royalty expense projection.

The objective of the analysis is to measure the net benefit to the debtor from not having to inbound license the intangible property. So when analyzing the transactional data, the appraiser should consider which party would be responsible for these intangible property maintenance expenses: the actual owner or licensee or the hypothetical owner or licensor.

In the application of the RFR method, the appraiser typically performs the following procedures:

1. Select and document the criteria to be used for selecting the comparable license agreements; such criteria could include type of intangible property, type of owner/operator, type of industry in which the property is used, size of the market in which the property is used, and dates and term of the license agreements.
2. Assess the terms of each selected intangible license agreement with consideration of:
   - the description of the bundle of legal rights for the licensed comparable property,
   - the description of any maintenance or other expenditures required for the comparable property (for example, product development, advertising, product promotion, or legal protection),
   - the effective date of the comparable license agreement,
   - the termination date of the comparable license agreement, and
   - the degree of exclusivity of the comparable license agreement.

3. Assess the current status of the industry and the associated relevant market and prospective trends.
4. Estimate an appropriate market-derived capitalization rate for the royalty expense projection; the capitalization rate considers the risk of the royalty expense projection and the UEL of the intangible property.
5. Apply the market-derived capitalization rate to the royalty expense avoidance projection in order to conclude a value indication.

The RFR method has particular application for the type of intangible property that is typically licensed between licensors and licensees. This method is also applicable when there are a sufficient number of comparable license agreements related to sufficiently similar intangible property.

The RFR method may be especially applicable when the intended standard of value is fair value or fair market value. That is because this valuation method is based on actual arm's-length transactions (licenses) between independent parties.

It may be applicable when the appraiser has access to the debtor's financial projections, especially debtor revenue projections. It may also be applicable when the appraiser has developed an estimate of the intangible property's UEL.

The RFR method may be less applicable in the following circumstances:

- In the analysis of intangible property that is not typically licensed between a licensor and a licensee
- When there is not a sufficient quantity of comparable license agreements or if the licensed intangible property is not sufficiently similar to the actual intangible property
- When the appraiser does not have access to the debtor's financial projections or cannot estimate the subject intangible property's UEL
- When the appraiser does not have sufficient information about which comparable transaction party (licensor or licenses) is responsible for the intangible property maintenance and protection expenses

Income Approach Appraisal Methods

In the application of the income approach, value is estimated as the present value of the future income from the ownership/operation of the debtor entity's property.

The present value calculation has three principal components:

1. An estimate of the duration of the income projection period, typically measured as the debtor property's UEL
2. An estimate of the property–related income for each period in the UEL projection, typically measured as either (a) owner income (e.g., lease rent or license royalty income), (b) operator income (e.g., some portion of the total business enterprise income), or (c) both
3. An estimate of the appropriate present value discount rate or direct capitalization rate, typically measured as the required rate of return on an investment in the debtor's property

For purposes of the income approach, the property UEL relates to the period of time over which the debtor entity expects to receive the income metric related to the subject property:

1. lease,
2. license,
3. operational use, or
3. forbearance of operational use.

In addition to the term of the UEL, the appraiser may also be interested in the shape of the UEL curve. That is, the appraiser may be interested in the annual rate of decay of the debtor property's expected future income.

For purposes of the income approach analysis, many different income measures may be relevant. If properly applied, these different income measures can all be applied in the income approach analysis to conclude a value indication.

Some of the different income measures that may be applied in the income approach analysis include the following:

1. Gross or net revenue
2 Gross income (or gross profit)
3. Net operating income
4. Net income before tax
5. Net income after tax
6. Operating cash flow
7. Net cash flow

8. Incremental income
9. Differential income
10. Rent or royalty income
11. Excess earnings income
12. Several others

Because there are different income measures that may be applied in the income approach, it is important for the capitalization rate (either the present value discount rate or the direct capitalization rate) to be derived on a basis consistent with the level of income measure applied in the appraisals.

Regardless of the measure of income considered in the income approach, there are several categories of appraisal methods that may be applied to value the debtor entity's property:

1. Appraisal methods that quantify an incremental level of property income—that is, the debtor entity may expect a greater level of revenue (however measured) by owning/operating the property as compared to not owning/operating the property.

   Alternatively, the debtor entity may expect a lower level of costs—such as capital costs, investment costs, or operating costs (expenses)—by owning/operating the property as compared to not owning/operating the property.

2. Appraisal methods that estimate the present value of actual or hypothetical lease or rent license royalty income—that is, these methods estimate the amount of actual or hypothetical lease or royalty income that the entity company (as licensor) would generate from the outbound license of the use of the subject property.

3. Appraisal methods that estimate a residual measure of property income—that is, these methods typically start with the debtor entity overall business enterprise income. Next, the appraiser identifies all of the tangible property and routine intangible property (other than the subject property) that are used in the debtor entity's overall business.

   These other properties are typically called "contributory assets." The appraiser then multiples a fair rate of return times the value of each of the contributory assets. The product of this multiplication is the fair return on all of the contributory assets.

   The appraiser then subtracts the fair return on the contributory assets from the debtor business enterprise total income. This residual (or excess) income is the income related to the subject property.

4. Appraisal methods that rely on a so-called profit split—that is, these methods typically also start with the debtor entity's business enterprise total income.

   Typically applied to the appraisal of intangible property, the appraiser then allocates or "splits" this total income between (a) the entity's tangible property and routine intangible property and (b) the subject property.

   The profit split percent (e.g., 20%, 25%, etc.) to the subject property is typically based on the appraiser's functional analysis of the debtor entity's business operations. This functional analysis identifies the relative importance of:

   a. the subject property and
   b. the routine (or contributory) assets—to the production of the debtor entity's business total income.

5. Appraisal methods that quantify comparative income—that is, these methods compare the debtor entity's income to a benchmark measure of income that, presumably, does not benefit from the use of the subject property.

   Such benchmark income measures typically include (a) the debtor entity's income before the subject property development, (b) industry average income levels, or (c) selected guideline publicly traded company income levels.

   One typical measure of income for these comparative analyses is the EBIT margin.

   When publicly traded companies are used as the comparative income benchmark, the method is sometimes called the comparable profit margin method.

All of these income approach property appraisal methods can be applied using either:

1. the direct capitalization procedure or
2. the yield capitalization procedure.

In the direct capitalization procedure, the appraiser:

1. estimates a normalized income measure for one future period (typically, one year) and
2. divides that measure by an appropriate investment rate of return.

The appropriate investment rate of return is called the direct capitalization rate. The direct capitalization rate may be derived for:

1. a perpetuity time period or
2. a specified finite time period.

This selection of the capitalization period depends on the appraiser's estimate of the subject property's expected UEL.

Typically, the appraiser concludes that the subject property has a finite expected UEL. In that case, the appraiser may use the yield capitalization procedure. Or, the appraiser may use the direct capitalization procedure with a limited life direct capitalization rate.

Mathematically, the limited life capitalization rate is typically based on a present value of annuity factor ("PVAF") for the subject property's expected UEL.

In the yield capitalization procedure, the appraiser projects the appropriate income measure for several future time periods. The discrete time period is typically based on the subject property's expected UEL. This income projection is converted into a present value by the use of a present value discount rate.

The present value discount rate is the investor's required rate of return—or yield capitalization rate—over the expected term of the income projection.

The result of either the direct capitalization procedure or the yield capitalization procedure is the income approach value indication for the debtor entity's property.

Appraisal Synthesis and Conclusion

In the appraisal synthesis and conclusion, the appraiser considers the following question: Does the selected property appraisal approach(es) and method(s) accomplish the appraiser's assignment?

That is, does the selected approach and the selected method actually quantify the intended objective of the debtor entity property analysis, such as:

- a defined value,
- a transaction price,
- a third-party license rate,
- an arm's-length intercompany transfer price,
- a damages measurement,
- a property bundle exchange ratio, or
- an opinion on the property transaction fairness.

With regard to a bankruptcy-related appraisal analysis, the appraiser also considers if the selected appraisal approach and method analyzes the appropriate property bundle of legal rights. The appraiser also considers if there were sufficient empirical data available to perform the selected appraisal approach and method.

The appraisal synthesis considers if there were sufficient data available to make the appraiser comfortable with the analysis conclusion. The appraiser may also consider if the selected approach and method will be understandable to the intended audience for the property appraisal.

The appraiser also considers which appraisal approaches and methods deserve the greatest consideration with respect to the subject property's expected UEL. The subject property's expected UEL is an important consideration in each appraisal approach.

In the income approach, the expected UEL affects the projection period for the property income subject to either yield capitalization or direct capitalization.

In the cost approach, the expected UEL affects the total amount of obsolescence, if any, from the estimated cost measure—whether that be the property reproduction cost new or the property replacement cost new.

In the market approach, the expected UEL affects the selection, rejection, and/or adjustment of the comparable or guideline sale, lease, or license transactional data.

The following factors influence the appraiser's consideration of the debtor property's expected UEL:

- Physical factors
- Legal factors
- Contractual factors
- Functional factors
- Technological factors

- Economic factors
- Analytical factors

Each of these factors is normally considered in the appraiser's UEL estimation. Typically, the life factor that indicates the shortest UEL conclusion deserves the primary consideration in the bankruptcy-related appraisal synthesis and conclusion.

Ultimately, the appraiser applies professional judgment to weigh the various appraisal approach and method value indications in order to reach a final value conclusion.

The appraiser's weighting of the value indications (whether quantitative or qualitative) is based on the following:

- The appraiser's confidence in the quantity and quality of available data
- The appraiser's level of due diligence performed on those data
- The relevance of the valuation method to the debtor entity property's life cycle stage and degree of marketability
- The degree of variation in the range of the value indications

Based on the appraisal synthesis, the debtor entity property final value conclusion can be (1) a point estimate (which is typical for fair market value valuations) or (2) a value range (which is typical for transaction negotiations or proposed license/lease/sale transaction fairness opinions).

Attributes of an Effective Bankruptcy Appraisal Report

There are numerous objectives of any property appraisal report that is prepared within a bankruptcy environment.

First, the appraiser wants to persuade the appraisal report reader (whether the reader is a potential transaction participant, the DIP management, a creditor, counsel for any party, a judge or other finder of fact, etc.).

And, second, the appraiser wants to defend the property value conclusion.

In order to accomplish these objectives, the content and the format of the property appraisal report should demonstrate that the appraiser:

1. understood the specific property valuation assignment;
2. understood the debtor entity's property and the subject property's bundle of legal rights;
3. collected sufficient debtor entity financial and operational data;
4. collected sufficient industry, market, and competitive data;
5. documented the specific property's economic benefits to the debtor entity;
6. performed adequate due diligence procedures related to all available data;
7. selected and applied all applicable income approach, market approach, and cost approach appraisal methods; and
8. reconciled all value indications into a final value conclusion.

The final procedure in the entire bankruptcy-related analysis is for the appraiser to defend the value conclusion in a replicable and well-documented property appraisal report.

The written property appraisal report will typically:

- explain the debtor entity property appraisal assignment,
- describe the debtor entity subject property and the subject bundle of legal rights,
- explain the selection of (and the rejection of) all generally accepted property appraisal approaches and methods,
- explain the selection and the application of all specific appraisal procedures,
- describe the appraiser's data gathering and due diligence procedures,
- list all documents and data considered by the appraiser,
- include copies of all documents that were specifically relied on by the appraiser,
- summarize all of the qualitative appraisal analyses developed,
- include schedules and exhibits documenting all of the quantitative appraisal analyses developed,
- avoid any unexplained or unsourced appraisal variables or appraisal assumptions, and
- allow the appraisal report reader to be able to replicate all of the appraisal analyses developed.

In order to encourage the reader's acceptance of the appraisal report conclusion, the appraisal report should be:

- clear, convincing, and cogent;
- well-organized, well-written, and well-presented; and
- free of grammatical, punctuation, spelling, and mathematical errors.

In summary, the effective (i.e., persuasive) debtor entity property appraisal report will tell a narrative story that:

1. defines the appraiser's assignment;
2. describes the appraiser's data gathering and due diligence procedures;
3. justifies the appraiser's selection of the generally accepted property appraisal approaches, methods, and procedures;
4. explains how the appraiser developed the appraisal synthesis and reached the final value conclusion; and
5. defends the appraiser's property value conclusion.

Summary and Conclusion

This discussion considered the various types of debtor entity property analyses that an appraiser may be asked to develop within a bankruptcy environment. For purposes of this discussion, the term property includes real estate and real property, tangible personal property, and intangible personal property.

For all debtor entity property appraisals, it is a best practice for appraisers to consider all of the generally accepted property appraisal approaches—including the cost approach, the market approach, and the income approach.

Each of these property appraisal approaches has the same objective: to arrive at a defined value indication for the debtor entity's property.

Within each of the generally accepted appraisal approaches, there are generally accepted appraisal methods and procedures that may be appropriate for the particular debtor entity property appraisal assignment.

As a best practice, the appraiser's selection of the specific appraisal approaches, methods, and procedures for the debtor entity's property is based on:

1. the particular characteristics of the debtor entity property,
2. the specific bundle of legal rights subject to appraisal,
3. the quantity and the quality of available data,
4. the appraiser's ability to perform sufficient due diligence related to that data,
5. the purpose and the objective of the specific appraisal, and
6. the relevant professional experience and the informed judgment of the individual appraiser.

The final value conclusion is typically based on the appraiser's synthesis of the value indications from each applicable property appraisal approach and method.

The generally accepted appraisal approaches, methods, and procedures summarized in this discussion are generally relevant to bankruptcy-related property appraisals performed for transaction, financing, strategic planning, taxation, accounting, litigation, and other purposes.

Accordingly, it is a best practice for both the bankruptcy party-in-interest and the counsel to the bankruptcy proceeding to be familiar with the generally accepted property appraisal approaches and procedures for purposes of:

1. selecting the appropriate appraiser,
2. relying on the appraiser's value conclusion, and
3. defending the appraiser's value opinion and appraisal report and any other work product.

Notes:

1. *Black's Law Dictionary*, 10th edition (Thomson Reuters, 2014).
2. 2020–2022 *Uniform Standards of Professional Appraisal Practice* (The Appraisal Foundation, 2022).

Robert Reilly is a managing director in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.

On Our Website

Recent Articles and Presentations

Robert Reilly, a managing director of our firm, authored an article that appeared in the September 2022 issue of *Practical Tax Lawyer*. The title of Robert's article is "Taxation Considerations Related to Equity Incentive Compensation Plans"

With labor shortages currently affecting many industries and with the low national unemployment rate, many private company owners are considering compensation incentives to attract and retain high quality employees. Some compensation incentives include equity-based compensation of various types. Robert's article summarizes what tax counsel need to know about the taxation issues and the securities valuation issues related to private company equity incentive compensation programs.

Robert Reilly also authored another article that appeared in the September 2022 issue of *Practical Tax Lawyer*. The title of Robert's second article is "Noncompete Agreement Tax Considerations in Corporate Acquisitions."

Corporate acquirers typically expect that seller noncompete agreements will be included in any corporate merger and acquisition (M&A) structure. Robert's article focuses on the type of transaction in which the target company is a private corporation and the sellers are employee-shareholders. He summarizes the taxation and other considerations related to an M&A transaction in which employee-shareholders are selling the private C corporation stock to a C corporation acquirer. Some of these considerations also apply to the corporate acquirer's purchase of a subsidiary company of a parent corporation seller. However, the principal focus of Robert's article is taxation and valuation guidance related to the employee-shareholders' sale of a closely held corporation. Robert also provides guidance related to the taxation and valuation of any intangible assets (including noncompete agreements) in such an M&A transaction.

Nathan Novak, a vice president of our firm, delivered a presentation at the Business Valuation and Litigation Services Conference, sponsored by the New York State Society of Certified Public Accountants, which was held virtually on May 16, 2022. The topic of Nate's presentation was "Evaluating and Applying Control Premiums."

Nate's presentation begins by introducing the concept of acquisition premiums and control premiums and their implications. He explores empirical data sources for such premiums. Nate compares equity-based premiums to invested-capital-based premiums. Finally, he discusses the application of equity-based premiums and invested-capital-based premiums in the valuation analysis.

Robert Reilly delivered a presentation at the 50th annual Wichita Property Tax Conference, which was held in Wichita on July 25, 2022. The topic of Robert's presentation was "How We Deal with Economic Disruption and Disequilibrium in the Unit Principle Valuation."

Robert's presentation begins by exploring indications of economic disruptions and disequilibria, including examples of each. He goes on to discuss using a functional analysis and due diligence to identify and quantify the impact of economic disruption on the taxpayer unit value. Robert then explores the impact of economic disruption on each of the three generally accepted property tax appraisal approaches. Finally, he discusses appraiser caveats regarding economic disruptions.

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Communiqué

In Print

Robert Reilly, Chicago office managing director, authored an article that appeared in the May 2022 issue of the *Journal of International Taxation.* The title of Robert's article is "Intellectual Property Valuations."

Robert Reilly also authored an article that appeared in the July/August 2022 issues of *Construction Accounting and Taxation*. The title of Robert's article is "Criteria for Claiming a Worthless Security Loss Deduction."

Robert Reilly also authored two articles that appeared in the September 2022 issue of *The Practical Tax Lawyer*. The title of Robert's first article is "Taxation Considerations Related to Equity Incentive Compensation Plans," and the title of Robert's second article is "Noncompete Agreement Tax Considerations in Corporate Acquisitions."

Robert Reilly also authored two articles that will appear in the November 2022 issue of *The Practical Tax Lawyer*. The title of Robert's first article is "Income Tax Consequences Related to Commercial Damages Awards." The title of Robert's second article is "Subjective Determination and Objective Determination for Claiming a Worthless Security Loss Deduction."

In Person

Robert Reilly delivered two presentation on July 25, 2022, at the 50th Annual Wichita State University Property Tax Conference. The titles of his two presentations were "How We Deal with Economic Disruption and Disequilibrium in the Unit Principle Valuation" and "Principles of the Unit Principle of Property Valuation."

We are pleased to recognize that Robert Reilly has once again been named as a member of the conference planning committee for the 2023 Wichita State University Annual Property Tax Conference. Willamette Management Associates is proud to provide support for this long-running national property tax conference.

Robert Reilly delivered a presentation on August 31, 2022, at the Texas CPA Society annual conference on Business Valuation, Forensic, and Litigation Services. The title of his presentation to the TXCPAS Conference was "Fair Value Issues—Avoiding Common Errors in the Development and Reporting of Fair Value Measurements."

Robert Reilly will address the annual conference of the National Association of Property Tax Representatives—Transportation, Energy, and Communications ("NAPTR-TEC") in Kansas City on October 25, 2022. The title of Robert's address to the NAPTR-TEC Conference will be "The Identification and Measurement of Obsolescence in Unit Valuation Principle Property Appraisals."

Curtis Kimball, Atlanta office managing director, delivered a presentation on September 27, 2022, at the 45th Annual National Trust Closely Held Business Association in Asheville, North Carolina. The topic of Curt's speech to this long-running annual conference was "Update on the Conflict between the IRS and Taxpayers on Valuing Interests in S Corporations and Other Pass-Through Entities."

In Encomium

Curtis Kimball was recently elected to serve as a discipline governor for the business valuation discipline of the American Society of Appraisers. Curt's term runs from July 1, 2022, through June 30, 2026.

Insights Thought Leadership Archives

❑ Summer Issue 2022
Thought Leadership in Professional Practices and Licenses Valuation, Damages, and Transfer Price Analyses

❑ Summer Issue 2021
Thought Leadership in Taxation-Related Valuation and Transfer Price Issues

❑ Summer Issue 2020
Thought Leadership in Property Tax Planning, Compliance, and Appeals

❑ Spring Issue 2022
Thought Leadership in Economic Damages Measurements and Forensic Accounting

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Thought Leadership in Unit Valuation Principle Property Tax Appraisals

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Thought Leadership in Intellectual Property Valuation, Damages, and Transfer Price Analyses

❑ Autumn Issue 2020
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Thought Leadership in Forensic Accounting, Special Investigations, and Economic Damages

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