

Business Valuation Issues That Give Valuators, Lawyers, and Judges Heartburn

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Overview of Presentation

- Reasons Understanding Business Valuation Methods and Principles are Important
- Typical Business Court Disputes That Involve a Business Valuation
- Standards of Value/Premise of Value
- Risk Adjustments to Value: Discounts and Premiums
- Documents and Information Needed to Perform a Valuation
- Considerations When Drafting Settlement Agreements That Involve the Right to Purchase a Minority Interest – Fair Value, Fair Market Value, Book Value, Modified Book Value, Formula Value
- Areas That Cause Heartburn in Business Valuation
 - Normalization of Financial Statements
 - Discount and Capitalization Rates
 - Adjustments to Value Due to Corporate Election (C-Corp v. S-Corp)
 - See Estate of Jones v. Comm’r, T.C.M. (RIA) 2019-101 and Kress v. United States, 372 F. Supp. 3d 731 (E.D. Wis. 2019).
 - Fraud Uncovered During Valuation

Reasons For Understanding Valuation Methods and Principles In Business Court Disputes

- Allows for Justifiable Critiques of Valuation Reports
- Cross Examination of Expert Witnesses
- Courtroom Presentations
- Settlement Negotiations

Business Court Disputes Involving The Valuation of a Minority Interest In a Closely Held Business

- Dissolution Actions
- Dissenter's Rights
- Preemptive Rights
- Put and Call Rights

Standards of Value

- **Fair Market Value** - The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.
 - See Revenue Ruling 59-60 § 2.02; § 20.2031-1(b) Estate Tax Regulations

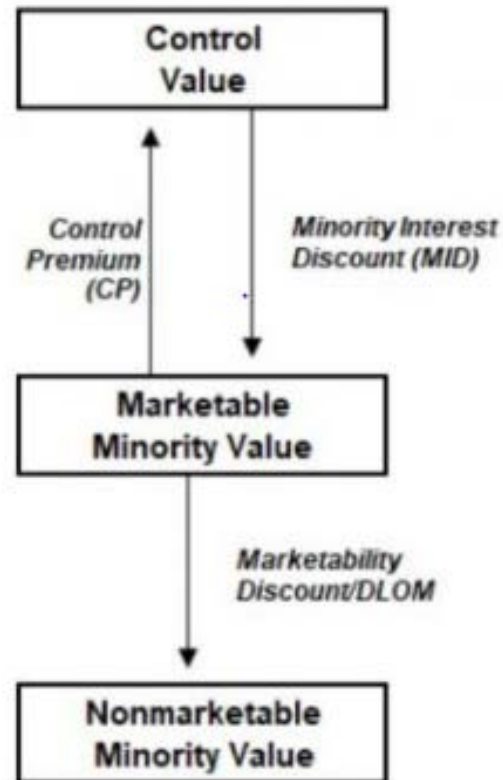
Standards of Value

- **Fair Value** - The value of the corporation's shares (i) immediately before the effectuation of the corporate action as to which the shareholder asserts appraisal rights, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable, (ii) using customary and current valuation concepts and techniques generally employed for similar business in the context of the transaction requiring appraisal, and (iii) **without discounting for lack of marketability or minority status** except, if appropriate, for amendments to the articles pursuant to G.S. 55-13-02(a)(5).
 - See N.C. Gen. Stat. 55-13-01(5); See also Royals v. Piedmont Elec. Repair Co., 1999 N.C.B.C. 1, 56-57 (Hon. Ben F. Tennille), affirmed, 137 N.C. App. 700, 529 S.E.2d 515 (2000).
 - Same as Fair Market Value on a 100% controlling interest basis (i.e., the value of the shares expressed as a pro rata share of the fair market value of a 100% controlling interest).

Premise of Value

- Going concern – expectation that business will continue to operate in the future.
- Liquidation – the net sales price if all assets are sold. Can be at arms-length or forced.

Risk Adjustments to Value: Discounts and Premiums



Documents and Information Needed to Perform a Valuation

- Financial Statements
- Budgets and Projections
- Tax Returns
- General Ledger
- Shareholder Agreements
- Asset and Depreciation Schedules
- SWOT - Strengths, Weaknesses, Opportunities, & Threats
- Past Transactions

<https://www.businessvalue.com/business-valuation-tools/>

Considerations When Drafting Settlement Agreements

- Standard of Value
- Premise of Value
- Tax Consequences: Timing of Allocating of Income and Losses
- Distributions/Dividends
- Assignment Conditions or Restrictions
- Cost of Appraisers

Areas of Heartburn

- Income Approach:
 - Normalization of Financial Statements
 - Discount and Capitalization Rates
- Fraud Uncovered During Valuation

Areas of Heartburn

Taxation Rates Affect Value: Applying the S Corporation Economic Adjustment Model (“SEAM”)

- Step 1: SEAM is used to quantify additional after-tax benefits to the S corp. shareholder from distributions and capital gains versus a C corp.
- Step 2: S corp. earnings are tax affected as if the company were a C corp. and then capitalized to give an “as if C corp. value.”
- Step 3: The adjustment factor representing the additional S corp. after-tax benefit is applied to the “as if C corp. value” to give an “as if S corp. value.”

Areas of Heartburn

Taxation Rates Affect Value: Calculation of Net Benefits to S Corp. Shareholder - “SEAM” Method

		<u>C Corp.</u>		<u>S Corp.</u>
Pre-tax Income		\$2,000,000		\$2,000,000
-Income Taxes (corporate)	36.0%	(\$719,600)		N/A
Net Income		\$1,280,400		\$2,000,000
x Dividend/Distribution Payout %	75.0%	0.75		0.75
Dividend (C) / Distribution (S)		\$960,300		\$1,500,000
-Income Taxes (personal)		N/A	45.1%	(\$902,000)
-Dividend Taxes (personal)	25.5%	(\$244,877)		N/A
Net After-Tax Distribution Benefit (A)		\$715,424		\$598,000
Net Income		\$1,280,400		\$2,000,000
-Dividend (C) / Distribution (S)		(\$960,300)		(\$1,500,000)
Capital Gain, Increase in Retained Earnings		\$320,100		\$500,000
-Effect of Increase in Tax Basis of Shares		\$0		(\$500,000)
Taxable Capital Gain		\$320,100		\$0
Gross Capital Appreciation, Before Tax		\$320,100		\$500,000
-Capital Gains Tax Liability on Taxable Gain	25.5%	(\$81,626)		\$0
Net After-Tax Capital Appreciation Benefit (B)		\$238,475		\$500,000
Net After-Tax Distribution Benefit (A)		\$715,424		\$598,000
+Net After-Tax Capital Appreciation Benefit (B)		\$238,475		\$500,000
Total Net Benefits to Shareholder		\$953,898		\$1,098,000
TOTAL BENEFITS, S CORP. VS. CORP.			15.1%	

Areas of Heartburn

Valuing the S Corporation With Tax Affecting, But Next Adjusting to Take Into Account Estimated S Corporation Additional Benefits

	<u>C Corp.</u>	<u>S Corp.</u>
Revenues	\$10,000,000	\$10,000,000
-Expenses	(\$8,000,000)	(\$8,000,000)
Pre-Tax Profits	\$2,000,000	\$2,000,000
<i>C Corporation Tax Rate</i>	36%	36%
-Corporate Level Income Taxes	(\$720,000)	(\$720,000)
Net Income	\$1,280,000	\$1,280,000
Divided by Capitalization Rate	20%	20%
"As if C Corp." Value of Shares	\$6,400,000	\$6,400,000
x Adjust. for Addit. S Corp. Benefits (15.1%)		1.151
As if S Corporation Value of Shares		\$7,366,400

Areas of Heartburn

S Corporation Benefits Considered and Incorporated in Other Courts

- Dissenting shareholder case — Delaware Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 327 (Del. Ct. Ch. 2006).
- Corporate merger case — Nathan Owen v. Lynn Cannon, Bryn Owen, Energy Services Group, Inc., and ESG Acquisition Corp., C.A. No. 8860 CB (Del. Ct. Ch. 2015).
- Family law — Bernier v. Bernier (Sept. 14, 2007, Mass. Sup. Ct.). There are several subject iterations of this case.

Resources: S. Corp., Other Valuation Issues

- Business Valuation Articles: <https://www.businessvalue.com/business-valuation-articles/>
- Business Valuation Cases: <https://www.businessvalue.com/business-valuation-cases/>
- Business Valuation Tools: <https://www.businessvalue.com/business-valuation-tools/>
- Shareholder Rights: <https://www.jmdlaw.com/wp-content/uploads/2018/08/The-Rights-and-Duties-of-Shareholders-in-a-Closely-Held-Business-in-North-Carolina.pdf>