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Adjusted deal price or unaffected market value? Delaware Supreme Court reverses "fair value" ruling

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To tax affect or not to tax affect?

Federal case revives the tax-affecting debate for pass-through entities

In *Kress v. United States*, the U.S. District Court for the Eastern District of Wisconsin *accepted* the practice of tax affecting the earnings of so-called "pass-through" entities. These include sole proprietorships, partnerships, limited liability companies and S corporations. The term "tax affecting" refers to reducing the earnings of a pass-through business for an assumed corporate tax rate. The court also *rejected* the application of a premium to reflect the tax advantages of owning a minority interest in a pass-through business.

Careful interpretation

In *Kress*, the court seems to say that there's no difference in value between minority interests in otherwise identical S and C corporations. This is significant because the IRS has taken the position for decades that the earnings of pass-through entities shouldn't be tax affected, because these entities pay no entity-level taxes. Many courts, including the U.S. Tax Court, have embraced this position.

When interpreting this opinion, it's important to note that it doesn't have the same weight as a U.S. Tax Court decision or IRS memorandum. So, it has limited precedential value beyond the Eastern District of Wisconsin.

Packaged gifts

In *Kress*, the plaintiffs — shareholders of Green Bay Packaging, Inc. (GBP), a family-owned S corporation — gifted stock to their children and grandchildren. The court was asked to determine the stock's fair market value on a minority, nonmarketable basis for federal gift tax purposes.

The plaintiffs' primary valuation expert valued the stock using the market approach. Their second expert used a combination of the income and market approaches, weighting the income approach at 86% and the market approach at 14%. The government's expert applied similar methodology, weighting the income approach at 40% and the market approach at 60%.

The plaintiffs' primary expert and the government's expert both applied corporate level taxes to the company's earnings "to effectively compare GBP to other C corporations." The plaintiffs' second expert used pretax multiples, essentially avoiding the issue but ascribing no valuation advantage to the company's S corporation status.

It's noteworthy that the government's expert tax affected GBP's earnings, given the IRS's long-standing position. His valuation did, however, add a premium to account for the tax advantages associated with S corporation status. He reasoned that GBP hadn't paid corporate taxes in any of the valuation years and didn't anticipate paying them in the future.

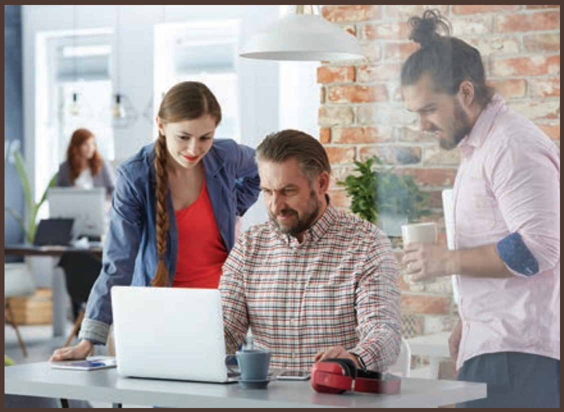
A "neutral" factor

The court chose the value set forth by the plaintiffs' primary expert, which was tax affected and did *not* include a premium for S corporation status. The court found S status to be a "neutral consideration with respect to the valuation of its stock." It noted disadvantages associated with subchapter S status, "including the limited ability to reinvest in the company and the limited access to credit markets."

Federal district court tackles family transfer restrictions

Family transfer restrictions may affect the fair market value of minority interests for gift and estate tax purposes. The U.S. District Court for the Eastern District of Wisconsin addressed this issue head-on in *Kress v. United States*.

In this case, the bylaws of Green Bay Packaging (GBP) prohibited family members from transferring shares of stock, except through gifts, bequests or sales of shares to other family members. The plaintiffs' primary expert considered this restriction in determining his discount for lack of marketability (DLOM) for gifts of stock to family members. However, the government asserted that doing so ran afoul of Internal Revenue Code Section 2703.



Under Sec. 2703, stock must be valued without regard to such a restriction unless it's:

- A bona fide business arrangement,
- Not a device to transfer property to members of the decedent's family for less than adequate consideration, and
- Comparable to similar, arm's-length arrangements.

Though GBP's transfer restriction met the first requirement, the court found the second requirement inapplicable. It concluded that reference to the decedent's family "unambiguously limits its application to transfers at death," despite regulations to the contrary.

In addition, the court ruled that the plaintiffs had failed to satisfy the third requirement, because they hadn't produced any evidence that unrelated parties dealing at arm's length would agree to such an arrangement. As a result, it concluded that the expert's consideration of the restriction was improper in estimating the DLOM.

Though not included in the court opinion, many valuation experts believe that S corporation status provides no real valuation advantage. Despite the lack of corporate-level taxes, shareholders of pass-through entities pay income taxes on their shares of the corporation's earnings at their individual rates, and S corporations typically distribute sufficient earnings to cover those taxes.

Plus, for tax years beginning after December 31, 2017, corporate tax rates have been permanently reduced under the Tax Cuts and Jobs Act (TCJA). So, avoidance of double taxation of C corporation profits (once at the corporate level and again when they're distributed to shareholders) is less of an advantage for S corporations under the TCJA than under prior law.

Stay tuned

For years, the valuation community has been at odds over whether it's appropriate to tax affect earnings when valuing minority interests in pass-through entities. It will likely remain a controversial subject. However, *Kress* provides some ammunition for tax-affecting proponents. ■

The cost of capital counts!

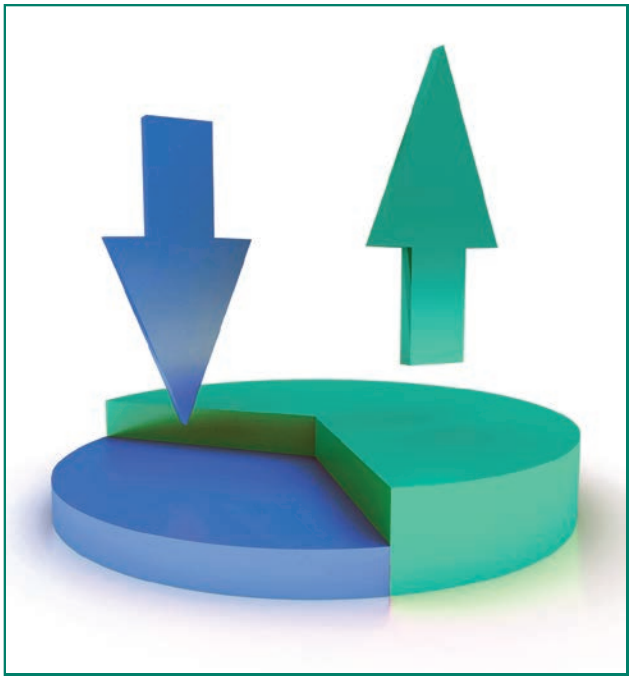
The cost of capital is an important consideration when valuing a business under the income approach. Here's how business valuation experts determine the "optimal" capital structure for a business and why it matters.

Debt vs. equity

Shareholders, partners and other equity investors expect to achieve a certain return in exchange for providing financing to a business. This may come in the form of 1) annual dividends or distributions, and 2) appreciation in the value of the investment. The latter payout comes when the business is sold or its assets are liquidated.

Some business owners strive to be debt-free, but a reasonable amount of debt can provide some financial benefits, particularly for a growing, profitable company. Currently, the cost of debt financing is near historic lows. In addition, business interest payments may be tax-deductible.

It's important to note that the Tax Cuts and Jobs Act (TCJA) limits business interest expense deductions for tax years beginning after 2017. This change could increase the cost of debt in some cases. However, many private businesses won't be affected by the limitation. There's an exception for small businesses (generally, those with average annual gross receipts of $25 million or less). The rules also allow certain real estate and farming entities to elect out of the limitation rules.



Capital structure

Even with the interest expense limitation, debt is still generally cheaper than equity. So, as the level of debt increases, returns to equity owners also increase — enhancing the company's value. If risk weren't a factor, then the more debt a business had, the greater its value would be. But at a certain level of debt, the risks associated with higher leverage begin to outweigh the financial advantages — and the cost of debt increases.

When debt reaches this point, investors may demand higher returns as compensation for taking on greater risk, which has a negative impact on business value. The so-called "optimal" capital structure comprises a sufficient level of debt to maximize investor returns without incurring excessive risk.

There are several options when choosing the capital structure to use when valuing a business, such as:

- The company's actual capital structure,
- The company's anticipated future capital structure,
- A prospective buyer's capital structure, or
- The optimal capital structure for comparable companies.

What's appropriate depends on several factors, including:

Level of control. If the interest being valued is a controlling interest, it's often appropriate to use the optimal capital structure. Why? Because a controlling owner generally can change the company's capital structure and will choose one that yields the most profitable results. If the interest being valued is a noncontrolling interest, it's customary to use the company's actual capital structure, because the owner of a minority interest lacks the ability to change how the business is financed.

Valuation purpose. To estimate fair market value, experts typically use the subject company's actual, optimal or forecasted capital structure. But if the standard of value is investment value, it may be appropriate to use the specific buyer's prospective capital structure.

Changes in business strategy. A company's capital structure fluctuates over time. It may be appropriate to use management's target capital structure if the actual structure has veered off course temporarily or if management plans to alter the company's capital structure.

Practical applications

Capital structure (the relative levels of debt and equity) affects the cost of capital. Generally, when using income-based valuation methods, experts convert projected cash flows to present value by applying a discount rate based on the cost of capital. The higher the cost of capital is, the lower the value of the business interest will be, all else being equal.

When valuing invested capital — that is, the sum of debt and equity in an enterprise — the weighted average cost of capital (WACC) is used as the cost of capital. WACC is a company's average cost of equity and debt, weighted according to the relative proportion of each in the company's capital structure.

Bottom line

Small changes in the cost of capital can have a major impact on value. A credentialed valuation expert knows how to evaluate the cost of capital based on the unique facts and circumstances of your assignment. ■

Searching for hidden assets and unreported income in divorce

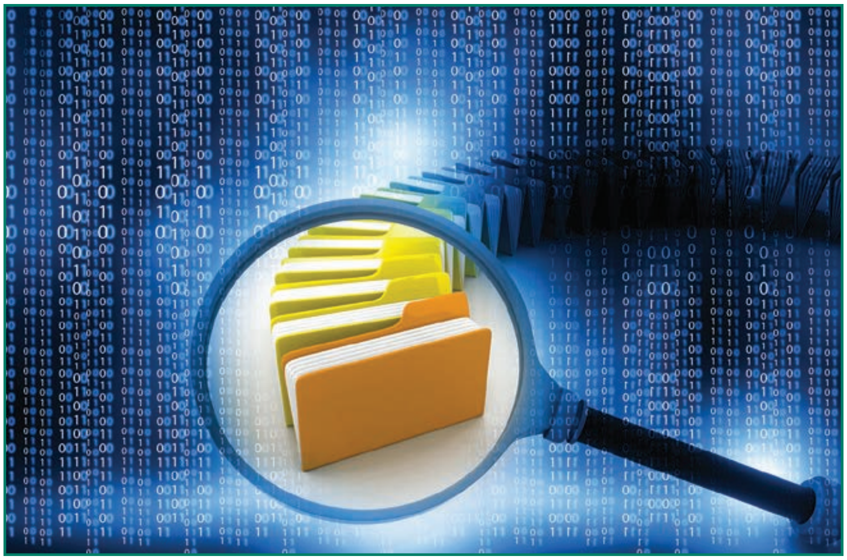
When high net worth individuals file for divorce, both sides have a financial incentive to hide assets owned and income generated by their marital "partnership." So, it's important to inventory the marital estate as soon as possible.

How to conceal wealth

A dishonest spouse may resort to creative techniques to maximize his or her share of the marital estate. Examples include:

- Physically concealing an asset,
- Denying that an asset exists,
- Deferring income and/or accelerating expenses,
- Falsifying documents,
- Transferring assets to a third party,
- Claiming an asset was lost, and
- Creating false debt.

For instance, cash is easily stashed in a safe or a relative's safe deposit box. Or a spouse may claim that expensive jewelry has been lost, when it's actually hidden under the mattress in the couple's former bedroom.



Cash also may be used to purchase art, jewelry, vehicles, boats and other personal property. These items may be overlooked or undervalued when inventorying the marital estate. Spouses may even ask their employers to delay paying commissions, raises or bonuses until after the divorce settles.

The biggest opportunity to conceal assets and income happens when the marital estate includes a private business interest, including rental properties. In addition to skimming cash from the business, the owner-spouse might try to depress business value by deferring income, accelerating expenses, understating assets and overstating liabilities.

How to uncover hidden assets and income

Proving that any of these events has (or hasn't) occurred can be challenging. Tax returns can provide a road map to income-earning assets and asset sales. They also identify sources of income, including W-2 wages, interest, dividends, rental income, and gains or losses from the stock sales. Each page of the tax return should be carefully examined.

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For example, Schedule A, "Itemized Deductions," may show a property tax deduction for undisclosed real estate assets. Schedule B, "Interest and Ordinary Dividends," may highlight foreign accounts and foreign trusts. And Schedule C, "Profit or Loss From Business (Sole Proprietorship)," might identify hidden business assets. Form 6521 contains the alternative minimum tax (AMT) calculation. Whether the taxpayer has incurred AMT tax could also help identify hidden assets, such as real estate and incentive stock options.

Other documents to request during discovery include:

- Personal and business bank statements,
- Pension and retirement account statements,
- Credit card statements and applications,
- Loan statements and applications,
- Insurance policies and bills, and
- Wills and other estate planning documents.

To unearth asset purchases and transfers, an expert will also need personal identification information for the other spouse and other individuals (such as friends and relatives) who might be complicit in the diversion of personal assets. This includes their full legal names and variations (nicknames, abbreviations and common misspellings), as well as known aliases.

Need help?

Unearthing unreported income and hidden assets can be difficult. But a trained financial expert can help find clues and open the facts for a fair and equitable settlement. The key is to hire your expert as soon as possible to minimize the opportunity for a dishonest spouse to conceal wealth, and to increase the likelihood of full and adequate discovery. ■

Adjusted deal price or unaffected market value?

Delaware Supreme Court reverses "fair value" ruling

Delaware's Supreme Court recently struck down the Court of Chancery's controversial statutory appraisal decision in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.* On appeal, the court rejected exclusive reliance on the unaffected (premerger) market price in favor of the deal price adjusted for synergies. Here are the details.

Lower court uses lowest value

In 2015, Hewlett-Packard acquired Aruba Networks for $24.67 per share. Dissenting shareholders brought an action in Chancery Court seeking a determination of their shares' fair value. The plaintiff's expert determined that the fair value per share was $32.57 using the discounted cash flow (DCF) method. Using similar methodology, the defendant's expert determined that the fair value was $19.75 per share.

The Chancery Court disregarded the DCF-based values. Instead, it considered the following market-based indicators of the fair value per share:

- The deal price less estimated synergies ($18.20), and
- The stock's average unaffected market price during the 30-day period before news of the merger leaked ($17.13).

The court relied on the latter, in part, because it found estimating synergies to be uncertain and error prone. It also maintained that the deal price included "reduced agency costs," which are internal costs associated with resolving conflicts between shareholders and management. Because these costs resulted from the merger transaction to which the shareholders dissented, the court ruled they should be excluded from fair value.

Rather than adjust for agency cost reductions, the court found that the unaffected market price provided "a direct route to the same endpoint." It ruled that reliance on market prices was compelled by the Delaware Supreme Court's recent decisions in *DFC Global* and *Dell*.

Appeals court rejects unaffected deal price

Delaware's high court took issue with several aspects of the lower court's decision. Notably, the appraisal statute requires fair value to be determined as of the merger's effective date. But the lower court used trading prices from three to four months earlier.

In addition, the Chancery Court's claim that it needed to deduct reduced agency costs from the deal price was based on an "inapt theory." The appeals court found that there was no basis in the record or in corporate finance literature to assume that the court's adjustment to the deal price for expected synergies excluded expected agency cost reductions.

Finally, the court rejected the idea that recent legal precedent compelled courts to rely on a stock's market price in statutory appraisal cases. Though *DFC Global* and *Dell* give weight to the "collective view of market participants," the deal price in an arm's-length merger accomplished through a "vigorous sales process" continues to provide strong evidence of fair value. ■

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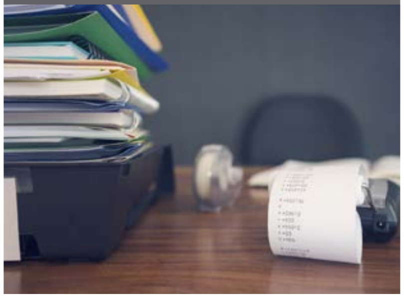

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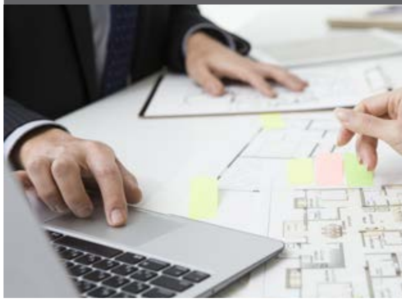

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