



INSIGHTS ON VALUATION

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Edward Giardina MSA CPA/ABV CVA

In professional practice since 1983, providing income and estate tax planning, tax preparation, financial statement reporting and business valuation services to business and individuals.

Member of the American Institute of Certified Public Accountants

Massachusetts Society of Certified Public Accountants

National Association of Certified Valuation Analysts

NACVA - Massachusetts Chapter

Braver Valuation Services, LLC.
2 Liberty Square
Boston, MA 02109
(617) 235-5000
eggiardina@thebravergroup.com

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How to Select a Business Valuation Expert

The selection of a business valuation expert becomes critical if you or your clients have a need to “know” what the value of a business is. There are several factors that must be considered before selecting an expert. The threshold consideration is the purpose of the valuation.



The following are obvious qualifications and characteristics that would apply in any engagement:

- Are they certified by a recognized national credentialing organization and subject to standards of work and ethics by that organization?
- Are they up-to-date in their education and knowledge of current events?
- Do they have deep and varied experience in valuing businesses (not just the type of business you want valued)?
- Do they have a depth of business knowledge outside of just valuing businesses?
- Do they and their firm have a reputation for being independent, objective, and reliable?
- Are they clear in their description of the work that is to be done, the information they will need to do the work, the time it will take, and the cost of the engagement?

The following are unique considerations in the context of some of the most common uses of a business valuation.

Litigation

Whether it is family court, civil court, probate, or criminal court, there is often a need to determine the value of a business or an ownership interest in the business in the context of conflict and emotion. In many cases information and documentation are not readily available, complete, or accurate. The valuation professional must demonstrate the abilities to:

- Make reasonable assumptions in the absence of reliable information
- Communicate and defend those assumptions and explain their ramifications on the conclusions and opinions they express
- Maintain objectivity and independence in the face of significant pressure to become an advocate
- Deal with difficult people who may not want to be helpful

Estate/Gift

The Internal Revenue Service is obviously a major player in the area of determining estate/gift tax due from the valuation of business interests. The valuation professional should have an excellent understanding of the reporting requirements imposed by the IRS. It would also be helpful if the professional had a current and working knowledge of relevant court cases and IRS regulations. A valuation professional in a planning setting is invaluable to preventing problems “down-the-road.” His or her ability to be helpful is strong knowledge and experience in this type of an engagement. If

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a family limited partnership or similar entity is being contemplated or is a part of the estate, the valuation expert can be critical in preventing problems and defending the entity as well as the value of the interest in the business.

Family Court

Every state's family court is different but one thing is common: In many divorce cases, the most significant asset to be handled is a closely held business. Very often this issue is, after child custody issues, the most emotional matter as accusations and allegations are traded about hidden income, personal expenses paid and deducted through the business, etc. On top of that, most family courts do not understand business valuation and do not have the time to dig into competing experts reports and/or testimony.

Therefore, the valuation expert should be experienced in this area of litigation and probably bring a few more skills to the table:

- Forensic accounting skills and experience
- Ability to find a middle ground and assist with settlement discussions
- Skills in working with opposing experts to identify the areas that need to be litigated if settlement is not possible
- An understanding of the interaction between business income/value and income for purposes of determining support

Where Do I Find an Expert? To find local valuation experts that are credentialed and have the knowledge and experience you are looking for, go to www.nacva.com and click on the "Need Your Business Valued?" link. The National Association of Certified Valuation Analysts is a recognized leader in the area of training and certifying valuation experts.

Key Man, Marketability, and Minority Discounts in Divorce Court



The Massachusetts Supreme Judicial Court (SJC) decision in the *Bernier* case (SJC 09836) was not just about tax affecting and the valuation of pass through entities. (See last quarter's newsletter for an analysis of the decision relating to that issue). The *Bernier* court also took on the issues of key man, marketability, and minority discounts in the context of a divorce.

The question of a key man discount arises whenever there is a dependency of the continued successful operation of a business

on the involvement of a particular person or persons. An obvious example would be the client relationships of a professional person. If

a professional disappears, his relationships also disappear. Key man dependency can arise other than in customer relationships, too. An individual can have unique knowledge or skill in industry matters, operations, or other aspects of a business. Such a dependency can be dealt with by properly training subordinates and successors, by the purchase of life insurance, or other means, all of which cost money. Thus, a discount is in order under the fair market value standard.

In *Bernier*, the key man discount question arose within the context of the valuation of a supermarket chain, where it was argued that the in-spouse president and CEO was so critical to the business that a discount should be allowed. The trial court allowed it, but the SJC overturned.

The SJC proceeded to lay down rules for when a key man discount is allowable and is perhaps the first state divorce court to venture this far out onto the slippery slope. They created two tests, either one of which establishes the permissibility of a key man discount. The first test is a two-part, conjunctive hurdle:

Are the services of the individual (a) critical to the financial success of the business, and (b) may be or will be lost.

In the *Bernier* case, the SJC found the discount was not justified under test #1 because the in-spouse stated in his testimony that he had every intention to maintain total ownership and control of the supermarkets. Therefore, while his services might be critical, it was not likely that his services would be lost.

The second test for a key man discount is as follows:

Are the services of the individual unique or irreplaceable, such as when the individual and the business are literally inseparable? An example would be a one-man professional business.

In the *Bernier* case, the SJC found that, while the services of the in-spouse were critical to the business, his services were not unique or irreplaceable, and no discount was justified.

The SJC referenced the *Nelson v. Nelson* decision of the Minnesota Court of Appeals (411 N.W.2d 868, 871 (1987) for its second test, and Revenue Ruling 59-60 and the *Estate of Feldmar v. CIR* (56 TCM 118, 130 (1988)) for its first test.

The SJC then went on to state that neither marketability nor minority discounts are allowed in the *Bernier* case, because of the husband's testimony negating any possibility of a sale. The SJC quoted the New Jersey decision in *Brown v. Brown* (348 N.J. Super. 466, 474-476 [2002]): "Neither marketability nor a minority discount should be applied absent extraordinary circumstances . . . Close corporations by their nature have less value to outsiders, but at the same time their value may be even greater to other shareholders who want to keep the business in the form of a close corporation." Massachusetts has clearly left behind the fair market value standard when it comes to marketability and minority discounts in divorce court, and it has joined other states in carving out a new fiduciary standard for divorce court.

Fundamentals of Fair Market Value



All business valuations are context-sensitive in that their outcomes depend on what is being valued, why it is being valued, and for whom it is being valued. The choice of an approach or approaches to value and the specific methodology employed should be based on the type and characteristics of the property being valued, any applicable legal requirements, and sensible and rigorous financial and economic analysis. To help define the valuation assignment and choose the appropriate approach(es) to value and the specific methodologies thereunder, the business valuation profession has developed a list of basic elements necessary thereto.

One of those elements is the standard of value being employed in the assignment. Since the word “value” can mean different things to different people, it is essential that the term be defined if the conclusion of value developed in the report is to have any meaning. The standard of value in a report tells the reader what definition of value is being arrived at in the particular assignment. The standard of value is different from the premise of value, which informs the reader of what assumptions have been made about the situation of the hypothetical transaction environment, e.g., going-concern or liquidation.

The critical information set forth in the standard of value includes whom the buyer and seller will be—it specifies the parties to the transaction. Put another way, the standard of value answers the questions, “value to whom?” and “under what circumstances?” In addition, the standard of value will dictate what valuation methodologies are appropriate and what other factors ought to be considered. One of the most prevalent standards of value is fair market value.

Fair Market Value

The concept first appeared in the Revenue Act of 1918, which provided that “when property is exchanged for other property the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value.”

Advisory Tax Board Recommendation 57 was issued by the Bureau of Internal Revenue in 1919 to define fair market value. The recommendation stated, “Market value” is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price. The adjective “fair” emphasizes the idea of fairness inherent in the conception of market value, and excludes any possibility of a construction of the words “market value” with reference to a market which, or to circumstances of sale under which, for any reason a fair price could not be obtained.

The opening sentence has been carried forward in some fashion to Revenue Ruling 59-60, where it is incorporated into that document’s definition of fair market value. The second sentence, which requires a “public of possible buyers” to be in place for buyers and sellers to transact at fair market value did not make the cut when Revenue Ruling 59-60 was published. And the last sentence is merely a tautology or circular reference that was dropped for good reason.

Revenue Ruling 59-60, in Section 2.02, defines fair market value, in effect, as 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. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Elsewhere in Revenue Ruling 60 the fair market value price is paid in terms of money or money’s worth, making it a cash equivalent price as was originally

mentioned in the Revenue Act of 1918. In addition, in 1929, the Board of Tax Appeals, the predecessor to the current Tax Court, developed the idea that the buyer and seller are hypothetical characters, and accordingly, this notion produces a value-in-exchange concept that is without regard to the specific current owner or any specific buyer.



Standards of value put the valuation report reader on notice as to the type of value being used in that valuation engagement. Common standards of value are fair market value, fair value, investment or synergistic value, ad valorem value for property tax purposes, etc. Since each of these values is defined in opposition to fair market value, let’s see how that standard of value is applied.

Fair market value is a concept that can be used heuristically to determine if a particular conclusion of value has met the definitional standard. For example, if the seller is motivated to sell because of business distress, the traded value will not be at fair market value because the seller is an unwilling seller in that he or she is under some compulsion and “needs” to sell rather than “wants” to sell. This type of seller is often defined as “motivated.” Another example is when the price offered by a competitor, who is attempting to gain market share, or perhaps trying to enter a new territory, contains a premium. As the business is worth more to this particular buyer because of the synergies expected to be realized after the purchase, then once more we do not have a transaction at fair market value. We have instead investment value, the value to a specific buyer, rather than a hypothetical buyer.

Very often we hear sellers tell buyers, “my price, your terms.” This often results in creative financing where the seller holds

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paper with a below-market rate of interest. Since this seller financing creates a price that is not cash equivalent, the transaction fails the fair market value test. When the buyer is not informed by the seller that a new competitor will be moving into the neighborhood nine months after the transaction closes, the price paid will not be at fair market value, as one of the parties did not have reasonable knowledge about a very relevant fact. Tied closely to the idea of reasonable knowledge, is the concept of what is “known or knowable” as of the valuation date, also known as the subsequent events doctrine. Since buyers and sellers do not have crystal balls and cannot be cognizant of events that will transpire after they transact, so too are business valuers restricted to what is known or knowable as of the date of valuation. To make use of information that comes to light after the date of valuation is to violate the fair market value standard.

For small businesses, where a financing rule of thumb is one-third each from the buyer, the bank, and the seller, those sellers who are unwilling to carry their third of the deal will not obtain a price equivalent to what the business is worth under the fair market value standard as they are not truly able to sell. Therefore, those sellers who are willing to sell but unwilling to finance are willing but not able sellers.

These examples offer practical applications of what fair market value means when the whole business is being sold. However, when 50% or less of a company’s stock is being offered for sale, other concepts must be considered before we can arrive at fair market value. Revenue Ruling 59-60 states: “Although it is true that a minority interest in an unlisted corporation’s stock is more difficult to sell than a similar block of listed stock” However, it does not go on to discuss what impact this has on fair market value or how to measure that impact. Further, since minority shareholders cannot force the sale of the company’s stock or its assets and are dependent on the majority shareholder for the size and timing of their dividends or distributions and ultimately when the whole business will be sold so they can reap their capital gains, they suffer from what is called a marketability discount. This discount is taken from the company’s 100% control value and, depending upon principally the amount of dividends and distributions expected to be received and the date of eventual sale of the whole company, can run as high as 80%. This discount from control value must be taken into account before minority shares can be considered to be at fair market value.

This article has attempted to put the idea of fair market value in some historical context and demonstrate how the ideas contained in its definition permeate the valuation process by impacting choices of approach, methodology, and discounts and premiums, among other items.



*If you have questions,
please contact our office.*

Edward Giardina
2 Liberty Square
Boston, MA 02109
(617) 720-5520
egiardina@thebravergroup.com