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compete, or similar arrangement between the stockholder-professionals and the corporation, which would serve to make the personal relationships of the stockholder-professionals the property of the corporation. Thus, there was no corporate asset to distribute.

The *Norwalk* case relied upon an earlier decision in *McDonald v. CIR* (3 TC 720 [1944]), in which the tax court determined that, while it is true that goodwill may be the subject of an exchange, an unsecured promise to share future revenues, if any, earned from former clients of the seller, may be so speculative in amount that it has no current fair market value.

So personal goodwill can be defined as an asset of the individual employee or stockholder that may or may not have current fair market value. And it can be further said that a contract between the individual and the corporate entity can serve to reduce personal goodwill value while creating corporate goodwill value. Then how does one determine the separate values of personal goodwill and corporate goodwill? One might pursue the following questions with the valuation subject:

Are there revenue streams or customer relationships that depend on the continued presence of an individual as opposed to the existence of the business entity?

If that individual departed the business and went into competition with it, what customers or revenue streams would be lost?

What is the current fair market value of the business, including its remaining goodwill, assuming those customers and revenue streams are gone?

Are there any agreements in existence that may serve to restrict or prohibit the individual from departing the business and/or competing with it?

If yes, what is the current fair market value of the business, including its goodwill, assuming the individual complies with the agreements?

What is the current fair market value to the individual of the customer relationships retained by him, in light of the agreements, if any?

Is it possible to determine a current fair market value for the personal goodwill, or is it too speculative to be valued currently?

Applying this inquiry will help determine to what extent the corporation or the individual controls the goodwill associated with a business, the value of the agreements which restrict the individual, and the values of personal and corporate goodwill. Please call if you have a question or need involving the value of personal goodwill. We are pleased to be of service to you.



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What you need to know about IRS Code Section 409A

Companies granting common stock options must set the strike price at or above fair market value on the date of the grant. This is true whether the company is publicly traded or privately held. The company's board established a stock option plan to motivate key employees. They wish to set the strike price greater than the fair market value so that key employees are motivated to increase stock value from the current fair market value to the strike price value and beyond.

For example, company A has common stock with a current fair market value of \$20 per share. The Board sets the stock option strike price at \$24 per share to motivate key employees to increase the stock value from \$20 per share to \$24 per share and beyond. When the value hits \$25 per share all owners, new and old, will enjoy the financial benefit.

Under IRS Code Section 409A, the IRS has expressed the same interest in seeing that the strike price is equal to or greater than fair market value. In our example, the IRS insists the strike price be equal to or greater than \$20 on the date of grant. To offer a strike price less than \$20 could result in immediate taxation,

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employment taxes, a 20% penalty, and interest charges. A strike price of \$16 would amount to a form of “nonqualified deferred compensation” creating an immediately taxable event for the value received below the fair market value (\$16 compared to \$20).

To avoid this pitfall, a comprehensive written valuation report should be prepared by a qualified valuator. Section 409A requires:

- 1) Fair market value must be determined using “reasonable application of a reasonable valuation method.”
- 2) Valuation must be performed by a qualified valuator possessing appropriate knowledge, training, and experience.
- 3) Valuation report updates are required at least annually, with significant changes (e.g., customer, product, new equity financing, etc.) requiring more frequent updates as they occur.

The valuator’s skill set should allow for adjustments should the subject company be: an early stage start-up, an established company with preferred stock and multiple rounds of financing, or a company currently planning an IPO. The valuation approach, methodology, and documentation will need to be adjusted according to the particular situation. The non-compliance teeth given Section 409A puts the pressure on the Board to see that reasonable methods are employed to support reasonable valuations—a task made more difficult if the capital structure consists of preferred and common stock and/or multiple rounds of financing.

Common stock value can be influenced by many factors. The obvious factors are the company specific factors: revenue growth rate and profit margin. Additionally, the degree of common stock control or voting rights can impact value with more control indicating greater value. The existence of transfer or sale restrictions serves to reduce common stock value. Capital structure, including preferred stock with participation, liquidation, or cumulative dividend preferences impact common stock value adversely.

A valuator will apply the experience and skill set necessary to consider the varied factors impacting company value. Each factor must be addressed with appropriate consideration to meet the requirements of management scrutiny, potential IRS review, and company financial statement auditors.



IRS: Discount for Lack of Marketability developments

One of the most subjective areas of a Fair Market Value business valuation is the discount for lack of marketability (DLOM). The discount is used to estimate the effect on the value of a business that results from the inability to readily convert the shares of stock into cash. There has been much made, in recent years, of questions posed about the basis for the traditional methods of estimating the discount—Initial Public Offering (IPO) studies and restricted stock studies. In some cases, the questions raised have severely undermined the reliance on the studies as well as the perception of the users of valuation reports as to the authority of opinions and conclusions based on those studies.

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Not only is the DLOM subjective, it is also a material adjustment to the value of a business. It is not uncommon for the DLOM to reduce the value of a business by 35% or more. Consequently, it is one of the most controversial and litigated aspects of a tax valuation—estate tax, gift tax, etc. The IRS is probably the largest and most influential user of “Fair Market Value” opinions. It routinely initiates audits and court challenges to opinions of discounts for lack of marketability.

There is probably no single organization that has led the valuation industry in developing definitions, theories, and the body of valuation knowledge than the Internal Revenue Service. For example, the long-accepted definition of “Fair Market Value” was established by the IRS in 1959 (Revenue Ruling 59-60). That definition is still used today and is generally recognized as the most concise and complete description of that standard of value. The IRS has reinforced its reputation as a leading opinion driver in recent days.

Recently, the IRS released “Discount for Lack of Marketability Job Aid for Valuation Professionals.” (This can be obtained at <http://www.irs.gov/pub/irs-utl/dlom.pdf>.) It was published for use within the IRS in 2009 and was released online for public access this year. It is possibly the most comprehensive and useful collection of opinion and research that can be found in one document. The document, for example, presents qualitative and quantitative methods (23 different approaches are presented) for quantifying a discount and also presents support and criticisms for the methods. Additionally, information is provided for each approach regarding how courts have viewed the approach and how prevalent the approach is in industry. The document, however, does not provide guidance on “the best approach.”

As the business valuation industry advances, there is no doubt that the IRS research and analysis of the DLOM will be hugely influential and persuasive. However, it is interesting that the footer on every page of the document (112 pages) says the following: “This Job Aid is not official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position.” One could be justified in thinking that such might be one of the most ignored admonitions ever issued by the IRS.



What role does Personal Goodwill play in your business?

Personal goodwill is an important concept in tax planning for the sale of a business and for the marital division of assets in many states. First, let’s define what it is. When you think about the value of any business, you must ask this fundamental question:

Is continuation of the gross revenue stream dependent to some extent on the continued presence of one or more individuals?

If yes, then what would happen to the gross revenue stream if the individual (1) is no longer present, and/or (2) becomes a competitor.

The answer to the question is a resounding “yes” when the valuation subject is a professional type business such as an accountant’s or physician’s sole proprietorship. But the answer is also “yes” for any kind of business wherein personal relationships drive repeat sales.

A good example of the latter is the U.S. Tax Court case *Martin Ice Cream, Inc. v. CIR* (110 TC 189 [1998]). Martin Ice Cream, Inc. was engaged in the distribution of ice cream products, including Haagen-Dazs. Mr. Strassberg owned 51%. He was responsible for all Martin’s sales to major grocery store chains and maintained personal relationships with the key buyers. There was no pre-existing covenant not to compete between Mr. Strassberg and Martin. When Haagen-Dazs bought back the distribution

rights, customer relationships, and related assets, the question arose as to who owned these assets: Martin or Mr. Strassberg. The IRS argued that all these assets belonged to the corporation. However, the court decided that Mr. Strassberg owned these assets, and it was he who sold them to Haagen-Dazs.

In *William Norwalk et al v. CIR* (TC Memo 1998-279) two accountants terminated their C corporation to continue separate practices. The IRS argued that there was a tax due from the corporation upon distribution of its goodwill to the two stockholder-professionals and a tax due from each stockholder upon receipt of the corporation’s goodwill. The tax court said there was no employment agreement, covenant not to