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# Insights on VALUATION

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## Update on the Valuation of Pass-through Entities


When entrepreneurs start a business, they must choose early on a type of entity for their new venture. Choices include a corporation, limited liability company, general or limited partnership. Along with the choice of entity comes the choice of income tax structure, which generally falls under two categories: entity level taxation or pass-through taxation.

Businesses with just a few owners and uncomplicated capital structures can utilize pass-through taxation as a way of minimizing the overall income tax burden that adjoins the transfer of earnings to the owners. Pass-through taxation means that the entity computes its taxable income, but the owners pay the tax. The remaining income can be distributed without further income tax consequences. Pass-through entities include “S” corporations, limited

liability companies, general partnerships, and limited partnerships.

As the number of owners expands, or as the type of equity capital issued gets complex, pass-through entity structures become unwieldy. Thus, nearly all publicly held entities are regular corporations (also called “C” corporations). These entities pay income taxes on their net earnings, and the owners then pay additional income taxes on dividend distributions.

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a negative impact on operating profitability and cash flow, two key factors examined by a potential buyer.

Another consideration for the business owner is what my business is worth and what can I do to maximize that value before I sell? Many business owners have unrealistic expectations of the value of their business and this can make it difficult for the sale of the business. A valuation analyst can advise the business owner what his or her business is worth and, through their analysis, suggest ways in which that value can be increased.

Although this article addresses the issue of business owners and retirement, it should be noted that an exit-planning strategy should be developed by all business owners, whether facing retirement or not, in order to prepare for unexpected events, such as disability or even death. Exit-planning should be a normal part of the business planning process.

Several valuation methodologies use data mined from observation of publicly traded stocks. Cash flow and earnings discounts rates are based on average publicly held company dividend and capital appreciation returns. The returns being measured by the data are after corporate income taxes, but before the taxes paid by the investor on the dividends and appreciation in value of the investment.

When valuing a pass-through entity, to what income stream should the discount rate be applied? One could subtract a hypothetical income tax provision from the earnings of a pass-through entity, to make it look more like the publicly held C corporations from which the valuation multiples are taken. But in the now famous tax court case *Gross v. CIR* (T.C. Memo 1999-254, affirmed by the 6th circuit), the court decided that subtracting an expense that no one actually pays is an error. The *Gross* case was about a minority interest. However, the same logic was applied by the tax court in its *Adams* decision (*Estate of Adams v. CIR*, T.C. Memo 2002-80), which dealt with a majority ownership interest.

The *Delaware Chancery* case, *Delaware Open MRI Radiology Associates, P.A. v. Kessler* (898 A.2d 290, Del. Ch. 2006) was the first national scope S corporation valuation case published since the *Gross* decision that gave consideration to the interplay of corporate and individual tax rates. The judge focused on disposable income in the hands of the stockholder as the common denominator between C and S valuation. This case did not present as an issue distributions of less than all the net income, nor were exit strategy and the likely willing buyer

issues in consideration. The judge calculated a 29% effective corporate tax rate that adjusted for stockholder taxes payable on corporate net income.

In *Dallas v. Commissioner* (TC Memo 2006-212) counsel for the taxpayer requested the tax court judge to consider the findings of the *Delaware Open MRI* case. The tax court judge declined to consider the *Delaware Open MRI* approach, claiming that the Fair Value standard for a *Delaware Chancery* case somehow rendered that decision irrelevant to a determination of Fair Market Value in tax court.

Other highly recognized tax court justices have commented publicly that they look askance at the new methodologies. Those in favor of tax affecting S corporation earnings have now seen several tax court cases decided against them. Proponents of the new methodologies have yet to see their day in tax court. Meanwhile, the controversy over whether or not to tax affect S corporation earnings continues to rage on among valuation professionals. **To tax affect or not to tax affect—that is still the question.**

How can a business be worth more to a buyer because a seller has made a simple tax election for his own benefit, especially considering that the buyer can make his own election, or the buyer may not qualify for the election? Regardless of whether a pass-through election has been made, the business will change hands in the same marketplace, and be subject to the same market forces and considerations by buyers and sellers.

On the other hand, the owner of an interest

in a pass-through entity puts extra cash in his pocket, cash that the C corporation owner had to pay to the government. Investment values are supported by cash flow in the form of dividends and capital appreciation. Pass-through entities deliver more net cash flow after tax to the owners than C corporations can deliver from the same corporate earnings. So from the point of view of an investor, there is reason to place a higher value on an ownership interest in a pass-through entity, because it delivers more net after tax dollars to his pocket. Pass-through taxation can also enhance the net proceeds to the owners upon sale of the business.

Consensus has now formed on the issue of how to calculate the net cash flow benefit of a pass-through entity without tax affecting. However, sound judgment is necessary to decide when to tax affect earnings, what weight to give to the value indications from the alternative income methods, and what weight to give to various market based methods. These choices depend on how long the investor will be able to enjoy the benefit of the extra cash flow, and what net proceeds he will reap if and when the business is sold.

The choice among methodologies is very much driven by the facts and circumstances of the case at hand. We will be pleased to discuss the facts and circumstances of your situation at your convenience.

According to a recent survey conducted by Orion Capital Group, LLC, 47 percent of middle market business owners are considering selling their businesses within three years, and, surprisingly, over 90 percent of those business owners have not initiated a planning process. By waiting for the last minute to make a decision to sell, these owners may be missing significant opportunities and not realizing the optimal value of the businesses they worked so hard to build.

What can the baby boomer business owner do? First and foremost, start early. Experts suggest that small firms get organized three to five years (some even say seven years) before they even start to think about transitioning out of their business. This long lead time is necessary for two primary reasons; first, prospective buyers have become more sophisticated and are looking for a long history of the business that includes good financial records and operating documentation; and second, it may take some time for the business owner to implement changes that can enhance the value of his or her business.

Business professionals such as valuation analysts, certified public accountants (including tax specialists), financial planners, and attorneys can orchestrate a comprehensive exit plan that will benefit the business owner in a number of ways, including minimizing taxes and legal fees related to the sale or transfer of a business to maximizing the price received for a business. For example, many buyers prefer that the owner remain with the business for a number of years after the sale in order to smooth the transition. If the owner waits until they want to walk away from the business without a transition period before they sell, this usually results in a lower sales price as the buyer perceives a greater risk without a transition period. Adequate planning that includes a transition period can eliminate the buyer's risk and result in a greater price for the seller.

Well documented financial information is an important consideration in the planning process. Many small and middle-market businesses look upon formally prepared financial statements as an unnecessary expense, but buyers gain a greater sense of comfort in looking at a financial statement that has been audited or reviewed by a reputable accounting firm than one that has simply been printed off the business' computer. And what goes in those financial statements is extremely important. If the owner is running a large amount of personal expenses through the business, this has

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## Goodwill Impairment Testing— FASB Updates



On September 15, 2011 the Financial Accounting Standards Board (FASB) approved changes that will simplify the rules for testing goodwill for impairment. Goodwill impairment occurs when the implied fair value of a company's goodwill declines to an amount that is less than its carrying amount on the Company's books.

FASB made these changes because preparers of private company financial statements expressed concerns about the recurring cost and complexity of performing the first step of the two-step goodwill impairment test required under FASB's rules. Current guidance requires an entity to test goodwill for impairment, at least annually, using a two-step process. In step one of the test, an entity is required to calculate the fair value of a company and compare the fair value with the carrying amount of the assets, including goodwill, on the company's books. If the fair value of the company's assets is less than the amount carried on the books, then the second step of the test must be performed to measure the amount of the impairment loss, if any.

A number of preparers from private companies recommended that the FASB consider allowing an entity to use a qualitative approach for testing goodwill for impairment to help reduce the cost and complexity associated with performing the current quantitative approach.

The amendments approved by FASB will reduce complexity and costs by allowing a company (public or nonpublic) to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of its assets. Specifically, a company will have the option of first assessing qualitative factors (events and circumstances) to determine whether it is more likely than not (meaning a likelihood of more than 50 percent) that the fair value of its assets is less than its carrying amount.

If, after considering all relevant events and circumstances, a business determines more likely than not that the fair value of its assets is less than the amount carried on the books of the business, then performing the two-step impairment test will be unnecessary. If the business concludes that the opposite is true, then it will be required to perform the first step of the two-step impairment test by calculating the fair value of its assets and comparing the fair value with the amount carried on its books as explained in current FASB guidance. If the amount of the assets carried on the books of a business exceeds its fair value, then the entity will be required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the new guidance, a business may choose to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step test.

The amendments expand upon the examples of events and circumstances that a business should consider between annual impairment tests in determining whether it is more likely than not that the fair value of its assets is less than the amount carried on its books. The amendments will not change how an entity measures a goodwill impairment loss. Therefore, it is not expected to affect the information reported to users of financial statements.

The amendments will be effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011.

## Baby Boomer Business Owners and Retirement: The Time to Plan is Now

Baby boomer business owners in the United States are looking to turn their years of sweat and toil into cash for retirement, but the faltering economy rapidly turned the seller's market of a few years ago into a buyer's market, negatively impacting value. Adding to their woes, the large number of baby boomers who own businesses wanting to sell will likely result in a glut of businesses on the market in the coming years, which can further depress prices. And finally, most business owners wait too late to begin exit-planning, and delays can be costly in time and money. But with a well-planned strategy implemented sooner rather than later, some business owners can still realize their dream of life on a tropical beach.

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