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FCG VALUATION CASE E-FLASH

Authored by Chris D. Treharne, ASA, MCBA, BVAL
of Gibraltar Business Appraisals, Inc. a member firm of FCG

Issue 13:9

J Estate of Louise Paxton Gallagher, Deceased, F. Gordon Spoor, Personal Representative, Petitioner v. Commissioner of Internal Revenue, Respondent
Docket No. 16853-08, T.C. Memo 2011-148, Filed June 28, 2011, Judge: James Halpern

Once again, the Tax Court was faced with having to decide between tax affecting income and not doing so for a pass-through tax entity. Although the court's analysis resulted in a value much closer to the taxpayer's asserted value than the IRS's conclusion, tax affecting was rejected

TAKEAWAY
Having recently (May 2011) had the pleasure of having dinner with Judge Halpern and sitting next to him on appraisal conference panel the next day, I can attest to his intellect and super-engagement with respect to business valuation issues. The preceding personal characteristics make him a demanding jurist, and one who deserves great respect.

The Gallagher opinion is rich in procedural analyses and valuation concepts that reflect Judge Halpern's understanding of and involvement in the issues presented before him. Notwithstanding my respect for the judge, I disagree with the ruling's conclusion that a business owner's value is not diminished by cash flows (deliberately differentiating the preceding from net income) that are adversely affected by income tax liabilities associated with entity income which are paid to the government instead of contributing to the value an ownership interest. Whether the liabilities are personal or entity liabilities is irrelevant if they adversely affect entity cash flows.

At the conference, the judge repeatedly said that experts have the opportunity to tell him a story, but the ending is his responsibility. If I should I appear before him, I pray that my story will justify rewriting the ending to stories like Gallagher. If I fail, the outcome will be the result of my inability to effectively tell my story to an intellectually competent and engaging judge.

THE FACTS
Louise Paxton Gallagher ("Decedent") died July 5, 2004, owning a 15% member interest in Paxton Media Group, LLC ("PMG" or "Company"), a company that owned daily newspapers and other publications, plus a television station. PMG's members had executed an agreement to maintain its pass-through tax status. Further, there was no expectation that the pass-through status would be discontinued.

Decedent's Form 706 indicated that the fair market value of the subject ownership interest was $34,936,000 based on an appraisal prepared by the Company's CEO.

However, the IRS asserted the value was $49,500,000.

In response, the estate hired an independent appraisal firm which appraised the value at $26,606,940. Prior to trial, the taxpayer hired a second appraiser who valued the Decedent's interest at $28,200,000.

Also prior to trial, the IRS hired an appraiser who concluded the value should be $40,863,000.

The taxpayer's second expert (hereafter, "taxpayer's expert") used Company financial data for the period ending May 30, 2004 (approximately five weeks prior to the date of death), asserting that Company's June 30, 2004 financial statements (dated approximately one week prior to the date of death) would not have been available to an investor on the July 5, 2004, valuation date. For similar reasons, the expert's market approach relied on first quarter (as opposed to second quarter) SEC financial statements of guideline public companies.

In contrast, the IRS expert used Company financial data as of the month ending prior to the valuation date, plus guideline public company data as of the end of the second calendar quarter.

The court accepted the IRS expert's second quarter public company data and the Company's June 30, 2004, financials, thereby rejecting the estate's argument that such information would not have been available to an investor.

Both parties' experts considered the income and market approaches to value the subject ownership interest.

The IRS expert identified 13 potential stocks for his market approach but narrowed the list to four.

In contrast, taxpayer's expert asserted that reliance on the market approach was improper "because no companies sufficiently similar to PMG exist to support the method's application." [quotation from the court's ruling presumably is not a direct quote of the expert's testimony]

The court criticized the IRS expert's choice of guideline public companies because PMG's size, product mix, growth (based on EBITDA and revenue), and leverage differed. Interestingly and with regard to product mix specifically, the court observed that PMG did not have Internet-based distribution channels, while all of the IRS expert's guideline stocks did. Ultimately, the court rejected the IRS expert's guideline public company method.

Turning to the experts' use of the income approach, the IRS expert relied upon EBITDA projections as his measure of economic income, and used June 27, 2004, as period zero of his present value analysis.

However, the estate's expert used "free cash flow" (net cash flow to invested capital) and May 30, 2004, as period zero of his discounted cash flow analysis. Recalling the above discussion, the expert believed the date of the Company's most recent financial information should be the basis for the analysis.

Next, the court considered the reliability of the experts' income projections. Having considered the experts' reasoning, the IRS expert's measure of economic income was accepted, but adjusted by the taxpayer-expert's depreciation expense because the IRS expert's "operating margin" did not include depreciation.

Having determined cash flow, the court turned to the controversial issue of tax affecting the Company's income. Taxpayer's expert tax affected his cash flow, while the IRS expert did not. Citing Gross v. Commissioner, T.C. Memo. 1999-254 as well as the taxpayer's failure to discuss and justify tax affecting income, the court rejected the adjustment to income, saying, "we will not impose an unjustified fictitious corporate tax rate burden on PMG's future earnings." In a footnote, the court further noted that the taxpayer's income tax rates (both personal and corporate) did not match the valuation date statutory marginal rates.

Needing to determine an equity discount rate (one of two components of the weighted average cost of capital, "WACC", discount rate), the court considered the taxpayer-expert's use of the capital asset pricing model ("CAPM") versus the IRS expert's use of the build-up method. The latter method was considered more appropriate, saying, "The special characteristics associated generally with closely held corporate stock make CAPM an inappropriate formula to use in this case." Having considered the facts, an equity discount rate of 18 percent was selected.

Even though the court rejected both experts' analysis with regard to the second component of the WACC discount rate, it accepted the IRS expert's conclusion because it "cannot be objectionable to petitioner, since [IRS expert's] proposed higher cost of debt results in a lower present value of expected cashflow." [insertion substituted for IRS expert's name]

To determine the WACC, appropriate weights must be assigned to the cost of equity and debt capital. Recalling the guideline public companies considered earlier in the market approach, the estate's expert used their capital structures to determine the WACC components' weights.

In contrast, the IRS expert proposed using the Company's book-basis capital structure.

Based upon the estate's objection to the IRS expert's reliance on book values, the court acknowledged the weights should be based upon market (not book) value. Yet, citing the taxpayer's objection to using the earlier cited guideline public companies in the market approach, the court rejected the estate's reliance upon them in the income approach for this specific characteristic. Accordingly, the book-basis weights were used by the court in its analysis.

After discounting the above determined cash flows using the WACC, analysts must reduce the conclusion by the Company's valuation debt long-term debt. Because the experts relied on different financial statements for their analyses (recall that the taxpayer expert's financial statements were dated approximately one month earlier than the IRS expert's statements), the court was forced to choose between debt principal balances that differed by approximately $300,000. For the reasons cited earlier, the June 27, 2004, debt levels were used in the court's analysis.

Having determined a value, the taxpayer's expert reduced it by his estimate of a working capital deficit relative to the working capital levels of the guideline public companies identified in the market approach. Again, the court rejected the expert's analysis, citing the inconsistency associated with rejecting the guideline companies in the market approach but relying upon them in this part of his analysis.

To reflect the Company's pass-through tax status, the estate then argued that the concluded value should be adjusted as follows:

1. add dividend tax savings (relative to the concluded C corporation value) for all income distributions in excess of the companies income tax distributions,
2. add a significant sum "to reflect the future value of the company's deductible goodwill, discounted back to the valuation date,"
3. add an amount "to account for the company's extra marginal debt tax shield."

Importantly, the estate maintained the preceding adjustments were proper under Gross v. Commissioner, cited above. Asserting that the taxpayer had misinterpreted Gross, the court rejected the estate's position.

Because the IRS expert's cash flows were presented on a control level basis, the court concluded that application of minority interest discount was appropriate. The IRS expert provided an extensive review of contemporaneous control premium studies (which can be used to determine minority interest discounts). While the court considered the expert's information, it disagreed with the proposed 17-percent discount. Relying on the same data, the court selected a minority discount of 23 percent.

In addition to a minority interest discount, a discount for lack of marketability ("DLOM") needed to be identified. Citing seven restricted stock studies having an average discount of 32 percent, the IRS expert selected a 31-percent DLOM.

In contrast, the taxpayer's expert selected a 30-percent discount based on 11 restricted stock studies plus four studies that that impute DLOMs from pre-IPO stock transactions.

Citing Furman v. Commissioner, T.C. Memo. 1998-157, the court stated that it has "previously disregarded experts' conclusions as to marketability discounts for stock with holding periods of more than 2 years when based on the above-referenced studies." Yet, because both experts relied on the same studies, the court accepted the IRS expert's 31-percent DLOM.

CONCLUSION

Having considered the facts and performed its own analyses, the court rejected the estate's various appraisal conclusions of $34,936,000, $26,606,940 and $28,200,000, as well as the IRS values of $49,500,000 and $40,863,000. Instead, the court concluded that the estate's interest should be valued at $32,601,640.

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