ComStock
ADVISORS

Know your value

The Tax Affect Debate Continues

In the Estate of Gallagher v. Commissioner (T.C. Memo 2011-148), the Tax Court accepted the IRS expert's position that tax affecting earnings was inappropriate for an operating company organized as an LLC under Kentucky law. The Court rejected the IRS expert's guideline company approach because of a lack of comparability with the subject company, along with many of the positions advanced by the Estate's expert due to a lack of detailed analysis. In addition to the tax affecting issue, this tax court opinion covers a number of other valuation issues.

Background

The decedent in Gallagher owned 3,970 units of Paxton Media Group, LLC ("PMG") on July 5, 2004 (the Date of Death - "Valuation Date"), representing a 15 percent (the largest block) ownership interest. PMG was originally formed in 1896 in Paducah, Kentucky to own and operate one newspaper. PMG grew by acquiring other newspapers and publications, and by July 2004, the Company published 28 daily newspapers, 13 paid weekly publications, a few specialty publications, and owned and operated a television station.

On December 26, 1996, PMG elected to become an S Corporation, and later converted to an LLC in 2001. On the date of the S election, a shareholder agreement was executed to protect the S status by restricting the sale of stock. The election and shareholder agreement restrictions were in place on the Valuation Date (the restrictions were carried forward to the LLC) and there was no plan to discontinue the LLC.

On February 1, 1999, PMG acquired a 50 percent interest in High Point Enterprises, Inc. ("High Point"), with an option to purchase the remaining 50 percent at fair market value upon the death of High Point's publisher. High Point's publisher died on May 4, 2004. PMG exercised its option to purchase the remaining 50 percent interest in High Point on October 22, 2004.

CHICAGO
129 W. Wesley Street
Wheaton, IL 60187
630.462.9100

CINCINNATI
1 Levee Way
Suite 3109
Newport, KY 41071
859.957.2300

COLUMBUS
1335 Dublin Road
Suite 225-A
Columbus, OH 43215
614.485.9470

WINSTON-SALEM
4400 Silas Creek Parkway
Suite 103
Winston-Salem, NC 27104
336.765.1155

comstockadvisors.com

PMG adopted two security option programs, one in 1996 and one in 2000, providing key executives of PMG with options to purchase units. As of July 2004, PMG had a total of 2,800 options outstanding, of which 2,298 were vested. The average strike price of the options outstanding was $2,786.

In February 2004, Wachovia Capital Markets, LLC, which PMG had hired to arrange and syndicate a $350 million senior security facility, distributed a confidential information memorandum ("CIM") to potential lenders in connection with the proposed facility. PMG intended to use the financing to secure additional capital for future acquisitions and to refinance its existing debt. The CIM's terms and conditions required PMG to adhere to scheduled principal repayments, with the final payment due in 7 years.

As of December 28, 2003, PMG's audited balance sheet showed total assets valued at $357 million, liabilities of $284 million, and members' equity of $74 million (rounded).

As shown below, each side offered multiple fair market values prior to trial:

Source	Comment	Value of Decedent's Units
David Michael Paxton (PMG CEO)	Form 706	$34,936,000
IRS	Notice of Proposed Adjustment	$49,500,000
SMK	Redetermination	$26,606,940
Richard C. May	Estate's Trial Expert	$28,200,000
KTS	IRS's Trial Expert	$40,863,000

The Estate's expert at trial, Richard C. May, relied heavily on the discounted cash flow method in valuing decedent's units, using the market approach only to establish a reasonable estimate of fair market value. After certain adjustments and applying a 30 percent discount for lack of marketability, he concluded a fair market value for the decedent's units of $28,200,000.

The IRS's expert at trial, John A. Thomson of Klaris, Thomson & Schroeder, Inc. ("KTS"), valued the units using both a market approach and an income approach. He applied a 17 percent minority discount to the result in the income approach, and applied a 31 percent discount for lack of marketability to the results under both approaches. He gave the results from each approach equal weight in deriving a fair market value of $40,863,000.

Points of Contention

The experts disagreed over the following issues:

- The date of financial information relevant to a date-of-death valuation of decedent's units.
- The appropriate adjustments to PMG's historical financial statements.
- The propriety of relying on a guideline company method.
- The application of the income approach. (including tax affecting)
- The appropriate adjustment's to PMG's enterprise value.
- The proper type and size of applicable discounts.

Date of Financial Information

Mr. Thomson bases his valuation on PMG's internal financial statements ending June 27, 2004, and financial information for comparable public companies as of the quarter ending June 30, 2004. Mr. May relies upon financial information for comparable public companies ending March 28, 2004, and PMG's internal financial statements ending May 30, 2004, the latest statements published before the Valuation Date.

The Court agreed with Mr. Thomson that the June 2004 financial information should be used in valuing decedent's units.

Adjustments to Historical Results

Mr. Thomson made one adjustment to historical results, subtracting a $7.9 million gain on divested newspapers in 2000. Mr. May made, among other adjustments, the following three adjustments: (1) Deducted the $7.9 million gain in 2000; (2) Deducted a $700,000 gain from a life insurance policy in 2003; (3) Deducted $1.1 million positive claim experience from PMG's self-insured health insurance plan in 2003.

The Court agrees with the gain adjustment made by both experts, but disregards Mr. May's other two adjustments because he provides no explanation as to why the gains were nonrecurring.

Mr. May also made adjustments for net pension income (or expense), and other income (or expense). In his report, Mr. May stated that PMG had an overfunded defined benefit plan. He eliminated the pension amounts from historical financial statements, adding the "full amount of the overfunding", $11.664 million, to enterprise value. The Court disregarded these adjustments, stating that Mr. May had failed to adequately explain both his calculation and the reason for assuming the overfunded plan provided no annual benefit in the discounted cash flow method. Because Mr. May also failed to adequately explain his other income (expense) adjustments, they were also disregarded.

Guideline Company Method

After identifying 13 potential companies, Mr. Thomson selected the four most similar to PMG. Relying on an Invested Capital to EBITDA multiple, and after reducing the median multiple by 10 percent to reflect differences between PMG and those companies, the fair market value of a marketable minority interest of $435 million was selected. A 31 percent discount for lack of marketability was then applied in finding a fair market value of $300 million.

The Court stated that Mr. Thomson failed to analyze sufficiently comparable public companies to warrant application of a guideline company method. The Court noted that publicly held companies involved in similar, rather than the same, lines of business may act as guideline companies. However, "As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies." (Heck v. Commissioner) The Court noted differences in size, products, revenue and EBITDA growth, and leverage and liquidity ratios. While the Court agreed that one of the guideline companies was arguably sufficiently similar to PMG, it noted that a single comparable company is an insufficient basis for the valuation method.

Discounted Cash Flow Method

Mr. May and Mr. Thomson disagreed on the following in finding a fair market value utilizing the discounted cash flow method: (1) PMG's projections; (2) Tax affecting of earnings; (3) Cashflow adjustments; (4) Amounts to be included in the rate of return; (5) Earnings adjustments to enterprise value; and (6) Discounts.

Mr. Thomson discounted PMG's net EBITDA, while Mr. May discounted PMG's net free cashflow. The Court agreed with Mr. May that net free cashflow was the appropriate measure to be discounted.

Both experts prepared their own economic projections rather than use the February 2004 multiyear forecast Wachovia Bank had prepared with its CIM. Mr. Thomson's revenue projections were much more conservative than Mr. May's, relying on historical results from 1999-2004 (excluding acquisitions), and adding in the growth anticipated from High Point. Mr. May assumed that PMG would grow at the same rate as the implied growth rate of the guideline companies. He did not include PMG's option to acquire the remaining 50 percent interest in High Point in future projection's because "it would be neither accretive nor dilutive to shareholder value because the price to be paid was to be fair market value."

The Court found Mr. Thomson's revenue growth projections to be more persuasive, noting that Mr. May acknowledged that his growth rates were significantly higher than the company's actual 2002 and 2003 newspaper growth rates. The Court also agreed with Mr. Thomson that revenue from the High Point acquisition should be included, since the completion of that acquisition was foreseeable as of the Valuation Date.

Mr. Thomson selected an operating margin (excluding depreciation and amortization) of 39.5 percent in each year of his projection, based on the budgeted 2004 operating margin of 39.2 percent and actual for 2003 of 39.6 percent. Mr. May projected an operating margin of 34.7 percent in 2004 and 34.1 percent for all subsequent years. In projecting operating margins, Mr. May selected a projected depreciation cost of 3.1 percent of revenue.

The Court found Mr. Thomson's analysis to be reasonable, noting it had no confidence in Mr. May's projection since it was based on improper earnings and newsprint cost adjustments. Therefore, it relied on a 39.5 percent operating margin before deducting a 3.1 percent depreciation expense in finding an operating margin of 36.4 percent. The Court also found Mr. Thomson's other income (expense) projection of 0.1 percent of revenue to be more persuasive, as well as his capital expenditure and working capital projections.

Tax Affecting

The Court's Memo next tackled the Tax Affecting Issue, citing the following: "Since most data on which stock valuation is based is derived from publicly traded C corporations, appraisers may tax affect an S corporation's earnings to reflect its S Status in its stock value."

Mr. May tax affected PMG's earnings by assuming a 39 percent tax rate, and assumed a 40 percent marginal tax rate in calculating his discount rate (we presume he tax affected the cost of debt) As discussed later in this article, Mr. May did make a later adjustment for S corporation distributions in excess of distributions needed for taxes. Mr. Thomson disregarded taxes in projecting both the company's cashflows and the appropriate discount rate. The Court declined to tax affect earnings and the discount rate, noting that Mr. May failed to explain his reasons and for employing two different tax rates. The Court then cited Gross v. Commissioner, "the principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden, a benefit that should be considered when valuing an S corporation."

Cost of Capital

The appropriate discount rate to be utilized was then analyzed. Both experts used the Weighted Average Cost of Capital ("WACC"), which the Court accepted but noted,

> "We have previously held that WACC is an improper analytical tool to value a "small, closely held corporation with little possibility of going public"." "Neither party has indicated the likelihood of PMG's becoming a publicly held company; however, because both experts used

WACC as the rate of return in their analyses, and neither party otherwise raised the issue, we shall adopt it, although we do not set a general rule in doing so."

The chart below illustrates the cost of capital components utilized by each expert, and what the Tax Court ultimately decided:

	Cost of Debt	Cost of Equity	W.A.C.C.	Debt/Equity
Richard C. May	5.0%	13.5%	12.3%	15%/85%
John A. Thomson	6.6%	20.0%	10.0%	75%/25%
Tax Court	6.6%	18.0%	10.0%	75%/25%

In finding its Cost of Equity, the Court disagreed with Mr. May's use of the Capital Asset Pricing Model ("CAPM"), and agreed with Mr. Thomson that the Build-Up Method was the more appropriate methodology. However, the Court disagreed with how Mr. Thomson utilized the methodology, which included a 2 percent premium to account for PMG's "S" corporate status.

Mr. Thomson selected his capital structure based upon PMG's current book debt/book equity percentages, adding that a minority shareholder cannot change the capital structure of the company, and that PMG is expected to continue to be more leveraged than the guideline companies. Mr. May relied on the capital structures of the guideline companies, and argued that market value of debt/market value of equity were the appropriate metrics. The Court agreed that the market value of debt and equity should be used, but ultimately decided to use PMG's own book capital structure. The Court also lent no weight to Mr. May's use of the guideline company capital structures, commenting that these were the same companies that weren't comparable enough for Mr. May to give any weight to the guideline company method. Finally, although the Court utilized the extremely high 75%/25% capital structure, it made two statements regarding the efficacy of this position:

"We agree that WACC is an improper discount rate tool for a company planning to pay down its debt, thereby changing its capital structure."

"However, given the parties' reliance on their own experts, both of whom use the WACC formula in their respective analyses, we must adopt the approach. Therefore, we will use Mr. Thomson's constant WACC rate in this case, although we do not intend to establish a general rule in doing so."

As discussed earlier, although Mr. May tax affected the earnings of PMG, he did make three adjustments to his DCF method to account for certain shareholder benefits: (1) Added $12.847 million to account for "S shareholder tax savings on all future projected distributions in excess of tax distributions"; (2) Added $44.262 million to reflect the future value of the company's deductible goodwill; (3) Added $6.693 million to account for the company's extra marginal debt tax shield. The Court disagreed with Mr. May on all three adjustments, noting that the savings of an S election are properly reflected through the imposition of a zero-percent corporate tax rate in valuing S corporations under the DCF method.

Stock Options Outstanding

Mr. May assumed that all of the outstanding options would vest and subtracted the expected proceeds from the option exercise, an in-the-money value of $12.1 million. Mr. Thomson calculated his per unit fair market value by using all issued and outstanding fully diluted units as of the Valuation Date, but did not include the cash received from exercise in his cash flows. The Court adopted Mr. May's approach.

Minority Discount

Mr. Thomson applied a 17 percent minority discount to his DCF, relying on the inverse of a 20 percent control premium, while Mr. May did not apply a minority discount to his DCF. The Court ultimately applied a 23 percent minority discount (the inverse of a 30 percent control premium), disagreeing with Mr. Thomson's use of a control premium (from which minority discount was derived) that is 10 percentage points below the median control premium and 20 percentage points below control premiums paid in PMG's industry.

Discount for Lack of Marketability

Mr. Thomson determined a 31 percent discount for lack of marketability after reviewing seven restricted stock studies, which show an average discount of 32.1 percent. He chose a 31 percent discount based on, among other things, PMG's established name and reputation, its upward trend in distributions, and its trend of redeeming shares.

Mr. May computed a 30 percent discount for lack of marketability based on the same seven studies, plus four additional restricted stock studies and two pre-IPO studies. He noted that PMG's stock was significantly more restricted and more likely to be held for a longer period of time than the studied restricted stock, characteristics leading to a higher lack of marketability discount for PMG's units.

The Court noted that it had previously disregarded experts' conclusions as to marketability discounts for stock with holding periods of more than 2 years when based upon the restricted stock studies. (Furman v. Commissioner) However, given both experts reliance on these studies, the Court accepted them for setting a benchmark and considered a 31 percent discount to be appropriate.

Conclusion

After making the above adjustments, the Court ultimately determined a fair market value for the decedent's units of $32,601,640.

We make the following general observations about this case, which was chock-full of valuation related issues.

While the Court identified certain differences between the guideline companies and PMG, if these tests were rigidly applied to most guideline company methods, this approach would rarely be approved by the Court.

Both the characterization of PMG as small and the noted dislike of WACC were surprising to this appraiser. The Court noted that utilizing the WACC for a company that was planning to pay down its debt was improper, as was using a capital structure based upon book values, but the Court accepted Mr. Thomson's positions anyway.

The Court acknowledged its preference for the use of the Build-Up Method rather than the CAPM. Mr. Thomson's equity risk premium of 11.7 percent appears to be the sum of the 7.2 percent large company return in excess of the income return on long-term bonds plus a 4.5 percent incremental return for companies in Ibbotson's 10a decile in the **2004 SBBI Valuation Edition**. This is a misapplication of the data. The 4.5 percent incremental return is in excess of CAPM, which reflects a leveraged beta of 1.42 in the 10a decile sample. If the leveraged beta of 1.42 was multiplied by 7.2 percent, this would have increased the cost of equity by 3.0 percent, all else held constant. In addition to this error, it is unclear how much of the company specific risk premium was related to the large amount of leverage assumed in a capital structure of 75%/25%. This type of leverage can increase the cost of equity dramatically. This issue is further clouded by the fact that if the market value of equity was utilized (rather than book value), the percentage of equity in the capital structure would have been higher than 25 percent.

In addition to the theoretical problems of applying a 0 percent corporate tax rate to PMG's earnings while utilizing rates of return from C corporations, there was also no discussion of the amount of distributions being made by PMG. Given Mr. May's small adjustment for distributions in excess of distributions needed for tax, and the large amount of debt currently in place, it appears unlikely that distributions would be paid close to 100 percent of pretax income.

The Court's minority discount calculation assumes that a large amount of control benefits were factored into the DCF, since the MergerStat data likely includes synergistic buyers.

The Court cites Furman v. Commissioner in stating its dislike for the use of the restricted stock studies:

> "finding the taxpayer's reliance on the restricted stock studies in calculating a lack of marketability discount to be misplaced since owners of closely held stock held long term do not share the same marketability concerns as restricted stock owners with a holding period of 2 years."

While we agree that the buyer of restricted stock in a public company has a different time horizon than the buyer of stock in a privately held company, the above sentence seems to imply that the buyer of closely-held stock somehow is less concerned about liquidity. The buyer of closely-held stock is **more concerned about liquidity**, since unlike the buyer of restricted stock, he or she faces an uncertain time period until liquidity.

About the Author

Brant Armentrout

Brant has more than 15 years of financial advisory and analysis experience. Since joining ComStock Advisors in 1999, he has performed more than 300 business appraisals in a wide variety of industries for various purposes, including ESOPs, estate and gift tax situations, shareholder disputes, family law matters, mergers and acquisitions, goodwill and other asset impairment tests, financial reporting, and fairness opinions.

He earned a Bachelor of Science in Business Administration and a BA in Social Studies Education from Wake Forest University. Brant is a CFA (Chartered Financial Analyst) charterholder, a Candidate Member of the American Society of Appraisers (ASA), and a member of the Executive Committee of the Carolinas Chapter of The ESOP Association.

©2011 Comstock Advisors