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FAIR VALUE™

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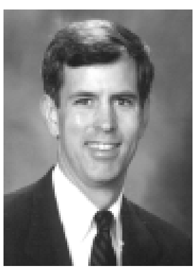
Key Recent Valuation Trends And Their Importance

By: George B. Hawkins, ASA, CFA

I. FAMILY LAW

A. North Carolina Legislature Overrides the *Christiansen* Case, Trashing the Concept of Fair Market Value. Until recent legislative action by the NC General Assembly, any consideration of post-separation data or events in a valuation prepared as of the date of separation could cause the valuator's report, findings and testimony to be inadmissible in an equitable distribution matter. This rule was the result of the *Christiansen* case. Complaints by citizens and attorneys, however, led the NC General Assembly to legislatively override parts of the case. Now, after the fact information can be used as corroborative evidence in considering the validity (or lack thereof) of the valuation findings at the date of separation.



George Hawkins

Banister Commentary. Family law attorneys continually rationalize why *Christiansen* was bad case law and why what actually happens after the fact should be relevant in determining fair market value and its reasonableness at the date of separation and this new legislative position certainly reflects that sentiment. Nonsense. Perhaps from a public policy perspective the judge ought to be able to consider what has since happened as a distributional factor in dividing up the marital pie, but this should not be confused with fair market value. Under the standard of fair market value, the buyer and seller *never* know the future with any such certainty; at best they can only make educated guesses. Neither has the benefit of hindsight in setting a value or in using later after the fact data to go back and see if they made an appropriate decision.

The standard in equitable distribution is the fair market value as of the date of separation. Fair market value is based on what is known, as of that date, and the price that a willing buyer would pay a willing seller with all relevant knowledge on that date. It makes no sense whatsoever for a valuator to use what happened to a company after the date of separation and to then go back in time to use that perfect knowledge in hindsight to value the company as of the date of separation, or for the court to use this later knowledge to determine if fair market value at that time was accurate. Do buyers in the real world have this luxury? Of course not. It's like buying public stock at $100 per share and then watching it drop to $50 due to the loss of a major customer to the company. What do you think the seller will say when you go back and ask him for $50 so you can be made whole? It seems that the General Assembly is confusing fairness and fair market value. Fair market value is not about fairness. It is about the market value of an asset and what a willing buyer would pay a willing seller. I may not believe it fair that my stock is now only worth $50, but that is its market value. It is what it is, whether I like it or not. Further, it is based on my best educated guess, using all of the knowledge available on that date, of what I think the most likely future holds for the business. If the future turns out differently, and it always does, even if to a minor degree, this does not mean that what I thought as a buyer was unreasonable at the time.

II. ESTATE AND GIFT PLANNING

A. The Next TAM: The Double Discount. In their enthusiasm for dreaming up circumstances which "manufacture" the biggest discounts in estate planning, some attorneys have latched on to the dangerous idea that if one set of minority and marketability discounts is available, why not make it two, three, or maybe even four. Their theory goes as follows: If I can take a minority and marketability discount for a limited partner interest in FLP A, why not take that interest and put it in yet another new family limited partnership, FLP B. Then my client can give away the limited partnership interest in FLP B and take not just one set of discounts, but two, effectively doubling the total discounts. In fact, some planners advocate layering discounts even further, putting the limited partner interest from FLP B into a new FLP C and so on.

Banister Commentary. This is financial alchemy at its finest and advocates of this position might as well start preparing their Tax Court trial briefs now, because this is a ludicrous technique that begs for and deserves a new Technical Advice Memorandum (TAM).

Unless there is objective market evidence to support their validity, in most circumstances the argument that minority and marketability discounts can be effectively doubled or tripled lacks common sense. The small limited partnership interest in FLP A already lacks any control to begin with (being a minority interest) and in addition is not readily marketable. Both of these factors are reflected in the value of the FLP A interest. Just because the FLP A interest is placed in FLP B and the limited partner interest then given away is FLP B does not mean that FLP B should have an additional substantial discount for lack of control. FLP B it never had this control to begin with, nor did its predecessor, the limited partner interest in FLP A. But the financial alchemist will argue that the new FLP B creates another new layer that the owner of the limited partnership interest must pierce before they can get to the value of the interest in FLP A. Come on. This is semantics at its finest. The truth is that the person buying the limited partner interest in FLP A never had the assurance or expectation to be able to get at the underlying value of the assets in FLP A. Putting another veil in the way by creating FLP B does not change the situation. There might be some validity to the argument that it makes the interest in FLP B marginally less attractive or perhaps harder to explain or understand. But to assume that layering confers the ability to take full double discounts seems to fly in the face of common sense.

B. IRS Lays Down the Gauntlet on Valuation Discounts. On its new form 709 (U.S. Gift Tax Return), the IRS for the first time now requires taxpayers to provide solid and objective support for the validity of any valuation discounts used.

Banister Commentary. The change in the form should not discourage taking valuation discounts if they are reasonable and supported by the facts. However, it is no longer enough to wing it when it comes to explaining the rationale for the discounts. Discounts, if they are appropriate, must be reasonable and supported. A well-prepared and professional valuation is based on unbiased analysis and the study of market evidence. This is the only way to arrive at meaningful discount.

C. Assault on Family Limited Partnerships. Several Technical Advice Memorandums and a recent Tax Court case make it clear that the IRS has launched an all-out assault on the validity of family limited partnership discounts. While most of the TAM's have dealt with unusual circumstances, it is clear that the Service is aggressively seeking to stop discounting dead in its tracks.

Banister Commentary. See our article "The Beginning of the End for FLPs?" in this issue.

D. The Swing Block Issue and its Impact on Discounts. Revenue Ruling 93-12 was lauded by the estate planning community as the Service's belated, but ultimate acceptance (in at least one specific instance) of the use of minority interest discounts for transfers of interests in family-owned, closely-held corporations. The ruling came after repeated IRS losses in the courts on its "family attribution" position. Previously, the IRS had maintained that even though family members might individually hold minority interests, the value of such shares should not be discounted for lack of control. This was based on the theory that family ownership should be viewed as one voting unit ("attributed") and assumed to act in unison. Therefore, under the Service's old position, no single family shareholder, even if holding a minority interest, suffered the reality of a lack of control. The IRS had maintained that minority discounts were not applicable to family interests and such interests should be valued based on their prorata share of the 100% control value of the business. In Revenue Ruling 93-12, the IRS formally conceded that minority discounts were applicable to transfers of interests in family-owned, closely-held corporations.

Despite Revenue Ruling 93-12, a new creature has appeared: the IRS "swing block" ruling. The issuance of *Technical Advice Memorandum (TAM)*

9436005 shows that the IRS is at least attempting to reduce or eliminate minority interest discounts with the consideration of "swing vote" attributes associated with a transferred interest. In effect, if a minority interest could be disallowed, the IRS is ultimately inferring that in some cases a minority share holding might even be valued as if it were a controlling interest.

Banister Commentary. There are real world situations where swing blocks can be quite valuable, so while the IRS position does have many conceptual weaknesses, there clearly are situations where this is a legitimate and unassailable valuation issue. In such a situation, a swing block interest could warrant a very different share valuation than a "regular" minority share interest. However, even before the swing block ruling was issued, not all minority shares were necessarily created equal. A properly prepared valuation of a minority interest considers the impact of various factors on the value of the minority interest. Included in these factors are the distribution of ownership, the rights of the minority holder conferred by state law, company bylaws, buy-sell agreements, voting trusts, and other factors. For a more detailed discussion of this issue, please see our Fall/Winter 1996 issue of *Fair Value* or call (704) 334-4932 for a copy.

E. Increasing use of Non-Voting Recapitalizations in Subchapter S Corporations. The year 1997 saw a surge of interest in the creation of a new class of non-voting common stock by S corporation owners for use in succession and estate planning (called the voting/non-voting recapitalization). Under this recapitalization, the owner gives away the new class of non-voting shares (either immediately or over time to the next generation) and takes valuation discounts for minority interest status, lack of voting rights, and lack of marketability. At the same time, the founder remains in control by holding some or all of the voting stock. As the next generation progressively proves their meddle over time, the founder can continue to give away voting shares until at some point majority voting control passes and the founder remains with a minority interest in the voting shares.

Banister Commentary. Non-voting recapitalizations make a lot of practical sense because they enable the founder of the company to remain in control until he or she is sure the next generation is ready, willing and able to maturely operate the business. While discounting opportunities are evident, many estate planners incorrectly assume that the following three discounts will always be large and available:

1. **Minority Discount.** Since the shares are a minority interest, they should be discounted for lack of control.
2. **Non-Voting Discount.** Since the shares do not have voting rights they must be worth far less than the equivalent voting shares.
3. **Lack of Marketability Discount.** Because the shares lack ready marketability (e.g., they are not traded on an exchange), this illiquidity should be reflected in a significant discount for lack of marketability.

While it is true that minority and lack of marketability discounts can be sizable, this is generally not true for a non-voting discount. Typically what is being gifted in non-voting form is a small minority interest. Except in unusual circumstances (such as a swing block), the limited number of votes of the small voting share block means its holder can't affect the outcome of a vote any more than can the holder of a small, non-voting interest. In reality there can and usually are discounts for non-voting shares. However, objective market-based data indicates that these discounts are generally limited as compared to the values for small voting minority interests.

III. HEALTH CARE

A. Specialist Medical Practices may be next on the Acquisition Hit List. With most hospitals, HMO's, and other health care mammoths having now acquired and built their primary care health care delivery networks, the next wave of acquisitions might well be of key specialist practices. However, not all specialties will be candidates for purchase. Expect hospitals to be highly selective.

B. Disillusionment over Physician Productivity Levels after a Practice Purchase will lead to changes in Compensation Schemes. The initial wave of primary care practice acquisitions by hospitals is now largely complete and some of these health care institutions are disillusioned with the results. Many institutions agreed to pay the acquired physicians guaranteed compensation without any incentive scheme to induce the doctors to continue working as hard as they had before their practice was bought. With physicians no longer having the incentive, some hospitals are complaining that certain doctors don't work as hard after the purchase, causing a drop in practice revenues and resulting in practice losses for the hospital. Look for hospitals to be much more reluctant in the future to agree to compensation contracts without performance expectations or formula adjustments.

IV. COMPANY VALUES

A. The Widening Disconnect between Private and Public Company Values. The bull market in stocks has led to all-time high valuation multiples paid by investors to own public company stocks. While acquisition multiples paid for private companies have increased over time, they are much lower than those paid for their public company brethren and the gap appears to be widening.

Banister Commentary. Unless your private company client is a possible candidate for a public offering, the historically high stock market multiples suggest that the public company valuation approach might lead to an overvaluation of the private company. Also, it further confirms that investors view public and private companies very differently (see the article *Public and Private Company Differences Can Have Major Valuation Implications*, by George Hawkins in the Spring 1995 issue of *Fair Value*). Finally, if highly sophisticated buyers of private companies (who typically have insider knowledge) are not willing to pay the multiples seen in the public markets is the stock market inherently overvalued or are other factors at work that are not present in the purchases of private companies? In fact, the answer may be a little bit of both. In the case of the latter, the continuous flow of liquidity into the market from aging baby boomers saving aggressively for retirement may be a fundamental element driving prices higher. This source of demand is simply not a factor in the market for private companies and may explain some or all of the diverging valuation measures.

B. Public Company Consolidators Acquire Private Companies in Diverse Industries, Driving Prices to All-Time Highs. A booming stock market and the access to cheap public capital have led to the day of the public company consolidator. Forming often as a shell company to raise huge amounts of public capital, these financial architects are attempting to acquire and consolidate what traditionally have been industries dominated by small, local private companies. Examples of industries where this is happening include: auto dealerships, funeral homes, scrap metal dealers, heating and air conditioning companies, hearing aid dealers, health care (ophthalmology, oncology, anesthesiology, neonatology, and dentistry) and video retailers, to name just a few.

Banister Commentary. How long this trend will last is unknown. However, if you have a client company in one of these industries, it may be that values are driven by these trends and should not be ignored as a possibly relevant valuation issue. To discuss any of the above issues, please call George Hawkins at (704) 334-4932. ♦

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