VIEWPOINT ON VALUE

SEPTEMBER/OCTOBER 2017

How to factor taxes into the business valuation equation

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Salkini v. Salkini
Submit timely business valuation reports — or else

Should you consider hiring a joint business valuation expert?

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Michael B. Lehner
CPA/ABV, CFE, ASA

zbt Certified Public Accounting & Consulting, LLC

Michael B. Lehner, CPA/ABV, CFE, ASA
732.412.3825
mlehner@zbtcpa.com
www.linkedin.com/in/michaellehnercpa
@MLehnerCPA
BusinessValuationNJ
www.zbtcpa.com

How to factor taxes into the business valuation equation

When valuing a private business interest, experts try to think like prospective investors. If you were buying a private business interest, would taxes affect how much you'd be willing to pay? Of course, investors consider a wide range of tax issues — such as expected federal and state income tax rates, deferred tax assets and liabilities, and built-in capital gains taxes — when evaluating investment options.

Quantifying future returns

Business valuation analysts often use economic returns as the basis for valuing a business interest under the income or market approaches. One type of return investors expect from a business investment is expected cash flows — and taxes are an expense that lowers cash flow annually.

But historical returns aren't the main focus: Investors want to know how much a company expects to earn in the *future*. Predicting a company's future tax rate can be somewhat tricky, however.

To the extent that a business has net operating losses and other deferred tax assets, the company's effective tax rate may be lower than published income tax rates. Conversely, deferred tax liabilities may cause the company to incur higher-than-expected effective income tax rates in the future.

Predicting future rates

Expectations about future tax law changes also may be factored into the value of an investment. The value of a business may decrease if:

- Federal or state tax rates are expected to increase, or
- Lucrative tax breaks will soon expire or be unavailable.

On the other hand, if the market expects tax rates to decrease or tax breaks to be expanded, it could increase a company's cash flow and, therefore, boost its value. In addition to paying dividends to investors, companies can use the incremental cash flow from reduced taxes to reinvest in new property or equipment, research new products, hire more workers and acquire other companies. All of these investment options could potentially increase future output and add value.

Calculating built-in capital gains tax

Another type of return on investment from a business interest comes when the business (or business interest) is sold. The value of a business that's operated and/or held assets for many years may have appreciated substantially, building up a significant capital gains tax liability.

A business's value may need to be discounted for built-in capital gains embedded in the business's appreciated assets. However, the likelihood of an imminent sale (or sales of key

Tax reform: Looking back to December 31, 2016

Private businesses are often valued as of year end, because it coincides with the cutoff date for their annual financial statements. Moreover, when valuing a business, most experts agree that you can use only information that's known or knowable on the "as of" date.

When predicting future taxes and projecting cash flow, it's important to think like a business owner on the valuation date. So, as of December 31, 2016, what were business leaders expecting?

The previous summer, House Republicans had published a tax reform blueprint, which called for a number of business-friendly tax law changes, including:

- Cutting taxes on "Made in America" products,
- Transitioning to a more competitive "territorial" system,
- Reducing the tax rate for most small, pass-through businesses to 25%, and
- Lowering the corporate tax rate to 20%.

Many business owners were hopeful that lower tax rates would boost future earnings. But there was also an overarching feeling of uncertainty in the marketplace about tax reform, along with health care coverage requirements and other government regulations.

In hindsight, we now know that tax reform efforts faced numerous challenges — and any final legislation that passes is likely to look markedly different from the House's original plan. However, such hindsight can't be factored into valuations prepared as of year end.

assets) is an important determinant when deciding whether to discount the interest 1) dollar-for-dollar for future capital gains tax, or 2) for the present value of the future capital gains taxes.

Considering entity type

Different tax rates also may apply depending on how the subject company is set up. C corporations are subject to two levels of taxation: once at the corporate level and again when income is distributed to shareholders. To help reduce taxes, many private businesses are organized as pass-through entities, such as S corporations, limited liability companies and partnerships. Pass-through entities aren't taxed at the entity level.

In October 2014, the IRS issued a guide for its valuation analysts on valuing minority interests in S corporations. According to the IRS guide, if a mixed pool of potential buyers exists for a minority interest, the buyer that would benefit from pass-through taxation will drive the ultimate transaction price.

So, the tax advantages of owning an interest in a pass-through entity may warrant a higher selling price than if the investor owned an interest in an otherwise identical C corporation. When valuing a minority interest in a pass-through entity, the IRS guide concludes that no corporate-level tax should be applied, unless there's compelling evidence that independent third parties dealing at arm's length would do so as part of a price negotiation.

Counting on a pro

Tax issues often muddy the waters when one is valuing a private business interest. Contact a business valuation expert for help unraveling the tangled web of tax matters in today's uncertain marketplace. ■

Pick a winner: Understanding pricing multiples

Courts often prefer the market approach for its perceived objectivity. But, like any technique, the market approach requires some professional judgment. Truly comparable market data can be hard to find, especially when valuing smaller private companies. Equally challenging is answering the question: What should the selling price be compared to?

The optimal "pricing multiple" depends on the nature of the company's operations and the factors that drive value in its industry. Here's an overview of common pricing multiples, along with some of their pros and cons.

Multiple pricing multiples

Under the market approach, a business's value is derived by comparing it to real-life transactions involving similar companies. There are two main sources of data to use when applying the market approach:

1. Public stock prices. The guideline public company method develops pricing multiples from market prices of stocks of companies that are engaged in the same or similar lines of business and that are actively traded on a free and open market.

2. Sales of public or private companies. The merger and acquisition (M&A) method derives pricing multiples from transactions involving controlling interests in companies engaged in the same or similar lines of business.

Whether the comparables are public or private transactions, valuation professionals can select from a varied menu of pricing multiples. Common multiples compare the selling price to:

- Revenue,
- Gross profits (revenues – cost of sales),
- Earnings,
- Earnings before taxes,
- Earnings before interest expense, taxes, depreciation and amortization (EBITDA),
- Sellers' discretionary income (with varying definitions),
- Operating cash flow, and
- Net free cash flow.

Pricing multiples can even be taken from balance sheet data. For example, an expert might compute multiples based on the comparables' book value or tangible net assets.

In the end, most valuation pros agree that no pricing multiple is perfect for all clients.

No cookie cutter techniques

For years, experts have been searching for the optimal pricing multiple. But, in the end, most valuation pros agree that no pricing multiple is perfect for all clients.

Some experts tend to favor the price-to-revenue multiple because it's simple and objective. They argue that profit-based metrics (such as earnings, EBITDA and sellers' discretionary cash flow) are inconsistently defined and subject to manipulation by the seller or the analyst.

Others advocate using the price-to-gross-profits multiple, finding that it often has the highest correlation with sales price. But price-to-gross-profits may not be the best choice when valuing a professional services firm, where individual skills are most important and materials costs are minimal.

The expert's choice of pricing multiple typically varies based on the nature of the subject company's operations. To illustrate, price-to-book-value may make more sense when valuing an asset-holding company or an asset-intensive business in which book values reasonably approximate current market values.

Conversely, when valuing small businesses (under $5 million in annual revenues), multiples based on discretionary income or EBITDA may be more meaningful, because they mirror small company M&A practices and generally address their desire to reduce income tax expenses. By comparison, public company investors and market analysts tend to be more sophisticated and may, instead, focus on price-to-earnings or price-to-net free cash flow.

Ultimately, valuation experts evaluate pricing multiples by considering what matters most from the perspective of hypothetical investors in the subject company. Are they most interested in revenue, cash flow, book value or some other performance metric? Regardless of the multiple that's selected, it's critical for the valuation report to fully explain and defend the multiple used to value the subject company.

A valuable exercise

Experts always *consider* the market approach when valuing a business. But they may opt to use the income or cost approach if they can't find a strong sample of comparables. When this happens, market data can still serve as a valuable reasonableness test for the value conclusion. ■

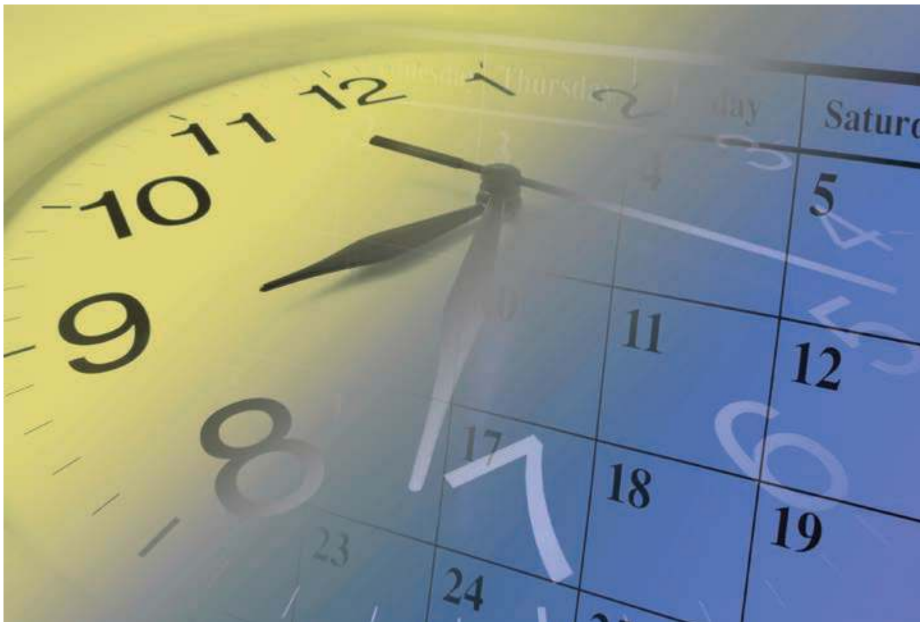
Salkini v. Salkini

Submit timely business valuation reports — or else

In a recent divorce proceeding, the Circuit Court for Howard County, Md., prevented the wife's expert witness from testifying regarding the value of a small telecommunications business that her husband had started three years prior to their marriage. The wife appealed the exclusion of her expert's opinion, as well as the amount she was awarded by the court. Here's what the Court of Special Appeals decided.

Money doesn't buy happiness

The husband started his business in 1994. It grew substantially after being awarded a contract with the U.S. military to provide 3G and 4G communications between 2011 and 2013. Throughout the marriage, the couple enjoyed a luxurious lifestyle with few limits on their personal spending. In addition to the business, they owned a home in Fulton, Md., valued at $2.2 million, as well as a second property



in Clarksville, Md., valued at approximately $600,000.

In 2013, the military upgraded its communications systems and didn't renew its contract with the husband's business. By 2014, it was clear that the business couldn't replace the contract.

To sustain the couple's lavish spending habits, the business issued the husband a $1 million line of credit. The loan agreement called for 3% interest and was due by March 31, 2016. The husband pledged the couple's principal residence as collateral. As of December 2015, the final balance owed to the business was nearly $1 million.

Based on the husband's annual income of $210,000, the trial court awarded the wife $2,090 per month in child support and $6,500 in indefinite alimony. The court also ordered the couple to sell their homes, split the husband's retirement accounts and retain certain personal assets. The husband was allowed to keep the business, and the wife was awarded $300,000 in cash.

Court excludes her expert's opinion

Under Maryland law, the court issued a scheduling order that set specific dates by which parties were required to "identify each person whom the party expects to call as an expert witness at trial" and complete discovery. The wife provided only the name of her valuation expert within the court's timeframe. Her attorney didn't provide a copy of her expert's report to the husband until the day before trial.

The husband argued that the wife's expert shouldn't be allowed to testify about the value of the business, because she'd failed to comply with the scheduling order. The trial court stated that discovery is designed to prevent either party from going to trial "in a confused or muddled state of mind, concerning the facts that gave rise to the litigation." And Maryland courts are given substantial discretion to apply sanctions for discovery failures.

The trial court called the wife's failure to give the husband a copy of the valuation of the business — the couple's most significant marital asset — a "substantial violation." As a result, the trial court wouldn't allow the wife's expert to provide a valuation opinion. But he was allowed to serve as a rebuttal expert to the opinion provided by the husband's expert, who valued the business at roughly $2.1 million (assuming the husband repaid the $1 million line of credit). The Court of Special Appeals upheld the trial court's sanctions.

Stay tuned

However, the appeals court was unclear exactly how the trial court arrived at the wife's $300,000 monetary award. So, the case was remanded to the trial court to determine whether the award was equitable and to spell out the specific factors that were considered in the final distribution of the marital estate. ■

Should you consider hiring a joint business valuation expert?

The use of a joint business valuation expert can often save resources. This strategy assumes that the parties will openly share information and trust each other. But it may not be realistic in all situations, including contentious divorces and shareholder disputes.

Sharing fees and information

When using a joint valuation expert, the parties will only be satisfied by the outcome if there's a mutual perception of fairness. Perceived fairness is enhanced when:

- Both parties have a say in the preferred valuation credentials and are allowed to interview candidates when hiring the expert,
- The valuation professional and both parties have full access to relevant information, such as tax returns, financial statements, responses to questionnaires and notes from site visits,
- Any time the expert communicates with the clients and/or their attorneys, the conversation or written notes are shared with both sides, and
- Both parties share in the expert's costs.

The expert should explain upfront that the valuation will be performed in an objective, unbiased manner. If either party suspects that a joint valuation expert is biased, dissatisfaction may ensue, possibly leading to appeals and additional fees.

Potential upsides

When the conditions are right, using a joint expert can benefit both sides. The benefits extend beyond just saving money and streamlining the valuation process. A joint expert also helps minimize disruptions to business operations from site visits, information requests and management interviews. These steps happen only once with a joint expert, rather than twice.

Additionally, parties that share a valuation expert prove that they can trust each other, improving the chances of effectively working together in the future. For example, buyers and sellers who share an expert to conduct M&A due diligence lay the groundwork for transitioning management from the seller to the buyer after the deal closes. Likewise, divorcing spouses who own a business may find it easier to co-parent their children or co-manage a family business after they use a joint expert to help settle their marital estate.

A joint valuation expert also may improve the odds of settling by giving the parties the opportunity to discuss issues and discrepancies out of court. But, if they do wind up in court, the parties' positions may be closer when using one expert who has full access to information, rather than two experts who may be using different data points.

Realistic expectations

There may be times when joint experts won't work — for instance, if one party to a lawsuit hides information or doesn't appreciate the value the expert brings to the table. For help evaluating whether a joint expert might work in a particular situation, consult with a business valuation professional. ■

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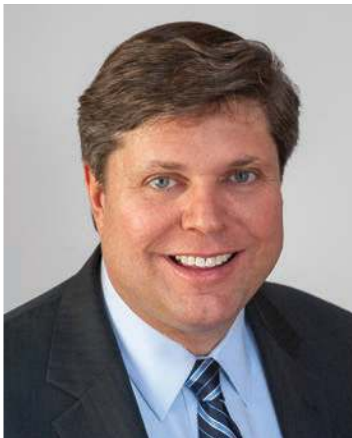
zbt Certified Public Accounting
& Consulting, LLC

MICHAEL B. LEHNER, CPA/ABV, CFE, ASA
BUSINESS VALUATION, FORENSIC ACCOUNTING & LITIGATION SERVICES

991 Route 22 West, Suite 200
Bridgewater, New Jersey 08807



MICHAEL B. LEHNER, CPA/ABV, CFE, ASA
Principal| Litigation & Valuation Services
mlehner@zbtcpa.com
732.412.3825

Michael B. Lehner is a Principal in the Bridgewater office of zbt Certified Public Accounting & Consulting, LLC. In his capacity as a recognized expert, Michael has prepared business valuations for various purposes including shareholder disputes, matrimonial proceedings, acquisitions and sales of businesses, gift and estate planning, succession planning, and commercial litigation. He also has extensive experience in complex litigation matters, including determination of damages and lost profits, and fraud and forensic investigations.

Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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