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Please contact us if you would like additional information on any of these topics or to discuss ways we may be of assistance to you in your client matters.

Michael J. Young, CPA/ABV, CVA
Partner, SC&H Tax & Advisory Services, LLC
(410) 403-1500

SPECIAL REPORT

2007 and Beyond: What Are the Big Issues in Business Valuation?

The IRS' enhanced oversight of appraisals and appraisers is certainly a hot topic in 2007, along with the continued evolution of valuing pass-through entities (tax-affecting). Fair value for financial reporting and related FASB pronouncements will continue to make news, as will efforts by the BV profession to create a convergence of practice standards.

Tax issues heating up

Last year was relatively quiet in the federal tax courts. The Fifth Circuit's holding in *McCord v. Commissioner* captured BV headlines, primarily for its reversal of the Tax Court's determination of marketability discounts.

But the decision turned on the continued viability of the defined value gift clause; so it leaves open the question of the appropriate methodology and data for determining discounts, which is bound to be a big issue in 2007. And though estate planners may be tempted to use the defined value gift clause, it may still flag the attention of IRS examiners as much as any high-dollar transaction or significant discount.

In another high-impact Tax Court case last year, *Dallas v. Commissioner* highlighted the continued uncertainty of valuing subchapter S Corporation earnings. In declining to tax-affect in an estate/gift tax scenario, the *Dallas* court distinguished the recent decision by the Delaware Chancery Court in *Delaware Open MRI Radiology v. Kessler*, which applied tax-affecting in an appraisal action. Rather than ending the debate, the distinction widened it, according to many BV analysts, so watch for tax-affecting to remain a key issue in the coming year.

IRS gets tough on appraisers, too

The passage of the Pension Protection Act of 2006 (PPA)—including its attendant penalties for appraisers and appraisals—will continue to impact the profession. Many see the new legislation as part of a bigger trend toward the creation, issuance, and/or revisions of standards applicable to the providers and users of BV services. In addition to the PPA, last year also saw:

- Substantial changes to the BV provisions of the Uniform Standards of Professional Appraisal Practice (USPAP)
- Yet another exposure draft on BV Standards from the American Institute of Certified Public Accountants (AICPA)
- Updated BV guidelines from the IRS
- FASB's release of SFAS 157 on fair value measurements (along with updates on SFAS 123R, 141, and 142) and its continued work with the International Accounting Standards Board (IASB) toward a convergence of fair value standards
- A new task force formed by the International Valuation Standards Committee (IVSC), charged with drafting global valuation standards and fair value guidance
- A similar BV task force formed by the Appraisal Foundation

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BV no longer a specialty

The rapid development and dissemination of new standards and new information has brought extraordinary change to the business valuation profession. While BV used to be a niche practice area, it's now considered by many to be a general practice area with various specialized niches, including fair value measurements but also valuations in health care, ESOPs, intangible assets, M&A, lost profits/economic damages, and the like.

To practice competently in any one of these niches requires significant commitment to the work and to greater accountability and credibility within the BV profession. In rising to the challenge to "raise the bar," BV practitioners will be seeking more opportunities to better serve their community of clients in the financial, auditing, and legal professions.

COURT CASE ABSTRACT

Allocation of Stock Purchase Price to Non-Compete Must Be Clear, Unambiguous

Becker v. Comm'r of Internal Revenue, 2006 Tax Ct. Memo LEXIS 268 (December 13, 2006)

The Tax Court reviewed the two primary rules governing the allocation of a portion of a stock purchase price to a covenant not to compete and found that the overriding standard—as in most contract construction cases—is the clarity of the provisions and, failing that, evidence of the parties' intent.

Family company buys out shareholder/son

Internecine disputes led the Becker Holding Corporation, a family owned, Florida citrus operation, to purchase all shares held by one Becker son for \$23.9 million, payable with \$5 million in cash and the remainder by an installment note. None of the purchase documents provided for an allocation of the price to a covenant not to compete, which the Becker son executed at the sale.

But in filing its tax return, the company allocated the \$5 million to the non-compete, declaring an amortization deduction. The IRS asserted a deficiency, consolidating the action with one against the son, who'd claimed capital gains tax on the total consideration paid to him

(and not ordinary income, as would have resulted from the company's characterization).

The relevant rules

In deciding the case, the Tax Court applied the standards of the 5th and 11th Circuits:

1. *'Strong proof rule' and 'mutual intent test'*. When considering tax allocation cases involving a covenant not to compete, the 5th Circuit adopted the "strong proof rule," which held that when the parties have set out the covenants with an assigned value, then only "strong proof" can overcome the declarations.

Over time, the 5th Circuit departed from the rule, adopting the more specific "mutual intent test," where the question becomes: "Did the parties...when they signed the agreement, intend to allocate a portion of the purchase price to the covenant not to compete?"

2. *Danielson rule*. In cases where the parties do allocate a stated portion of the purchase price to the non-compete, then the rule of the *Danielson* case (3rd Circuit, 1967), adopted by the 5th and 11th Circuits, applies:

A taxpayer who enters into a transaction...to sell his shares and executes a covenant not to compete for a consideration specifically allocated to the covenant may not, absent a showing of fraud, undue influence and the like...challenge the allocation for tax purposes.

The *Danielson* rule holds true even if, as in that case, "the explicit allocation had no independent basis in fact or arguable relationship with business reality."

Both rules consistent with this case

Both the Becker son and the IRS contended that the *Danielson* rule applied, as the purchase documents clearly allocated the entire consideration to the stock. Therefore, the transaction should result in capital gains to the taxpayer, with nothing allocable to the non-compete, as the company argued.

The company claimed the "mutual intent" test controlled, because the parties intended to allocate some value to the non-compete, and thus the Court should independently determine its value. (Note: Neither party obtained an appraisal at the time of the stock purchase agreement.)

The Tax Court held that the outcome was the same under both standards. The purchase documents

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clearly allocated the entire price to the shareholder's stock (*Danielson* rule). Although the parties obviously considered the non-compete an important element of the deal, nothing in their transaction—including their discussions and negotiations—evidenced a mutual intent to allocate a portion of the price to that provision (mutual intent test).

Notably, the company had argued the parties' failure to obtain a formal valuation of the shareholder's stock had evinced ambiguity about allocating a value to the non-compete. But the Court firmly disagreed, stating that the "absence of a third-party appraiser does not render the purchase documents ambiguous," especially when the parties themselves clearly valued the stock at \$23.9 million.

COURT CASE ABSTRACT

Another Court Considers The Distinction Between Personal vs. Enterprise Goodwill

***Gaskill v. Robbins*, 2006 Ky. App. LEXIS 364 (December 8, 2006)**

In this Kentucky divorce case, the wife was a successful oral surgeon, having opened two practices during the marriage, to which the husband had contributed his tax and accounting skills.

At trial, in valuing one of her practices, the wife's expert attributed a zero value to goodwill. In his opinion, the goodwill was all "personal"—that is, derived entirely from the wife's individual skills, reputation, and knowledge. He concluded that the fair market value of her practice was \$114,000.

The husband's expert took the opposite view. Without distinguishing any separate components, he included goodwill in his overall calculations, concluding that the wife's practice had a fair market value of nearly \$670,000.

Trial court felt compelled to value goodwill

The trial court rejected the wife's valuation, saying, "[T]here is no reported legal authority for the distinction in goodwill" made by her expert. In fact, in adopting the valuation by the husband's expert, the lower court held, "[I]t is generally accepted in Kentucky that the goodwill of a closely held medical corporation should be assigned value in a dissolution proceeding."

On appeal, the wife contended that the family court "operated under the misconception that it was compelled to assign a goodwill value" to her practice, and the Court of Appeals agreed. While Kentucky law requires considering goodwill in the valuation of a medical practice, it does not compel its inclusion. Thus, the case merited remand.

A chance to join the majority

At the wife's urging, the appeals court also considered whether Kentucky law should join the majority of U.S. jurisdictions in distinguishing enterprise and personal goodwill in divorce actions.

The wife cited a survey from a 2003 West Virginia case, *May v. May*, in which the state Supreme Court found that twenty-five U.S. jurisdictions made the distinction, with only enterprise goodwill constituting divisible marital property. Kentucky fell into the minority of twelve that do not exclude the personal component from the overall goodwill of a business and/or professional practice. (The remaining states have not directly addressed the issue.)

After a brief discussion of the majority/minority views as well as related Kentucky law, the Court of Appeals in this case decided it was "not inclined to deviate from long-standing precedent by creating a wholesale change of law holding that 'personal' and 'enterprise' goodwill should be distinguished for purposes of property valuation in a divorce proceeding"—not even in the case of a sole proprietorship.

Precedent aside, principles of equity persuaded the Court to continue to hold that the "form of the business enterprise [cannot] defeat the [marital] community's interest in the professional goodwill." Any other ruling, it said, would ignore the contribution made by the non-professional spouse to the success of the professional—as in this case, where the husband had contributed his financial time and skills, among other things, to the wife's practice.

Leaves question for the state Supreme Court

As in the *May* case, which went through an appeals process to the highest state level, the Kentucky Court of Appeals may simply have deferred the ultimate question to the state Supreme Court.

In a dissent, a senior appellate judge opined that "'personal' goodwill should not be considered marital property to be divided between the parties." However, he added, "[T]his is a matter to be addressed to our Supreme Court," as both the trial and appellate courts had not erred in their rulings under current Kentucky law.

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The SC&H Team of Experts



Michael J. Young, CPA/ABV, CVA

(410) 403-1513

MYoung@SCandH.com

Over 24 years of experience; serves as expert witness in litigation issues regarding economic damages, valuation, and fraud matters.



Jill D. Baker, MBA

(410) 785-8055

JBaker@SCandH.com

Over 12 years of experience; expertise in business valuation, banking, corporate finance, and M & A advisory.



Nathan E. DiNatale, CPA/ABV, CVA, CFE

(410) 403-1521

NDiNatale@SCandH.com

Over 12 years of experience; focuses on litigation support and economic damages litigation; serves as expert witness in valuation and litigation cases.



D. Scott Emge, MBA, CPA/ABV, CVA

(410) 785-6745

SEmge@SCandH.com

Over 13 years of experience including business valuation, corporate finance and financial and economic consulting.



Expert Testimony

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Certified Public Accountants
Management Consultants

910 Ridgebrook Road
Sparks, MD 21152
(410) 403-1500