



Valuation Insights

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DOL abandons appraiser-as-fiduciary rule

In late January, the Department of Labor (DOL) announced that it will abandon the “appraiser-as-fiduciary” rule from its planned reproposal of a broader fiduciary rule. As reported in the January 2015 issue of ASA’s *Capital Action* publication, the ASA has learned that when the DOL repropose a broad set of rules affecting fiduciaries and prohibited transactions, the proposal will not include a proposal to classify appraisers as fiduciaries in connection with valuations of employee stock ownership plans (ESOPs).

This is great news for business appraisers. If appraisers had been subjected to the duties of fiduciaries when performing an ESOP valuation, they would have been placed in a position of owing a special duty of care to a party to the ESOP transaction, which runs counter to the objective, unbiased role appraisers are supposed to play in any valuation assignment. In addition, the additional risks and cost of fiduciary insurance coverage that would have been imposed on appraisers would likely have made ESOP valuations cost prohibitive for all but the largest valuation firms.

Estate of Franklin Z. Adell v. Commissioner, T.C. Memo 2014-155, Filed August 4, 2014.

The Facts:

Mr. Franklin Z. Adell (“the decedent”) died on August 13, 2006. At the time of his death, among other assets, the decedent owned a 100% interest in STN.com (“STN”), a cable uplinking company created to provide services to one customer, a non-profit religious network called The Word Network (“The Word”). Mr. Kevin R. Adell, son of the decedent (“Mr. Adell”), and the decedent, created The Word in 1999 as a 24-hour station to broadcast urban religious ministries and gospel music. Mr. Adell called upon his personal relationships with religious leaders and churches to gain support and programming for The Word. The decedent was the president and a director of The Word, and Mr. Adell was the treasurer, secretary and a director. In addition, Mr. Adell served as the president of STN, however, he did not have an employment agreement or non-compete agreement with STN.



The Word entered into a services & facilities agreement with STN in 2000 which stated The Word would pay STN a monthly programming fee of “the lesser of actual cost or ninety-five percent of net programming revenue received by The Word in a one month period”. STN received at least 95% of revenue from The Word

each month up to and after the decedent's death, which was STN's primary source of income as The Word was their sole customer. STN's expenses included rent payment to the decedent's wholly-owned property holding company, compensation to its officers and employees and personal benefits to both the decedent and Mr. Adell, including paying for luxury cars, real estate and furnishings purchases, and personal litigation expenses, among other things. Officer compensation for the decedent ranged from approximately \$2,000,000 to \$7,355,000 between 2002 and 2006, while Mr. Adell received compensation ranging from approximately \$223,000 to \$1,293,000 between 2002 and 2006.

Mr. Adell filed the decedent's original estate tax return on November 13, 2007. The return showed, among the other asset values, a value of the decedent's 100% ownership of STN to be valued at \$9.3 million. The estate amended the return twice. First, in November of 2008 to recharacterize a \$6.6 million payment to Mr. Adell as a gift instead of a loan receivable for the Estate. The second amendment was submitted in August of 2010. On the second amended return, the estate changed their original position and reported the value of STN at \$0 instead of the original \$9.3 million.

The IRS issued a notice of deficiency on November 9, 2010, in which they determined an estate tax deficiency of \$39,673,096, noting that the value of the STN stock was over \$92.2 million instead of the original \$9.3 million originally reported by the estate.

The Court was asked to determine the fair market value of the 100% equity interest in STN owned by the decedent, as of his date of death, and whether to apply a substantial estate tax valuation underpayment penalty.

The Arguments and Findings:

The estate's first expert originally valued STN as an operating entity on the basis of observed increases in revenue over the historical years analyzed, the projected income and discussions with STN's management team regarding its current and forecasted operations. The expert indicated that an income-based approach was most appropriate as STN was expected to produce positive cash flows and an asset based approach would undervalue STN. The expert made various financial adjustments including taking an economic charge for Mr. Adell's personal goodwill which ranged from 37.2% to 43.4% of sales over the historical period and from 43.7% to 44.1% over the forecasted period. In addition, because there was no employment agreement or non-compete agreement in place with Mr. Adell, the expert believed a hypothetical buyer would not purchase STN if Mr. Adell could leave and take his relationships with him. Thus, using a discounted cash flow method (DCF), the expert valued STN at \$9.3 million.

In the amended return filed in 2010, the estate's expert changed their position. The expert indicated that he had a new understanding of the services agreement, which he had not previously accounted for, which imposed a limitation on STN's programming fee. The expert believed the limitation prohibited STN from making a profit and, although this limitation had not been previously enforced, a hypothetical buyer of the company would not place any weight on the historical performance given the terms of the agreement with The Word. Because STN had only one customer, it was thought there would be no other sources of revenue. The expert determined the adjusted fair market value of STN to be \$4.3 million as of the date of death, using the adjusted book value method. In addition, a second appraiser from the same firm, using the same methodology, independently came to the same value. The resulting decline in value was directly attributable to the methodology used.

The IRS's expert utilized a DCF method and determined the fair market value as of the date of death to be \$26.3 million. The IRS's expert utilized identical projected revenues, however, did not apply a charge for the personal goodwill of Mr. Adell. The expert assumed a hypothetical buyer would retain Mr. Adell at a reasonable compensation similar to the rate he had been earning, of approximately 8.1% of sales. Furthermore, the expert applied a

25.5% discount rate compared to the 20.0% discount rate used by the estate originally, as well as applied a 20.0% discount for lack of marketability. However, the discount rate was applied to significantly higher net cash flows than the estate's expert had utilized.

The Court indicated that the estate presented "conflicting expert reports and three different values" of the value of the decedent's STN ownership. The Court stated that the use of the Adjusted Book Value Method by the estate's expert is not credible. By using unproven limitations of the service agreement between The Word and STN, he expert incorrectly assumed that STN was not a profitable company". The Court noted that over the historical period The Word did not enforce the limitations on STN's programming fee, and management did not indicate there were any plans to do so in the future. The Court noted that as of the date-of-death STN was profitable and therefore it was reasonable to assume it would continue to be. As a profitable company, the Court determined that an income approach was the most appropriate method to determine the value of STN's stock.

The Court noted that the most significant difference between the varying conclusions of value was due to the treatment of the intangible value provided by Mr. Adell to STN. The estate's expert applied an economic charge for Mr. Adell's personal goodwill that increased STN's operating expenses, thereby decreasing its projected net cash flows. The IRS's expert determined a fair market salary for Mr. Adell of approximately 8.1% of sales (or \$1.3 million) was all that a hypothetical willing investor would have to pay to retain Mr. Adell's services, resulting in a higher stream of net cash flows and a higher valuation of STN's stock. The Court agreed with the estate's expert regarding the goodwill of Mr. Adell. The Court stated that Mr. Adell did not transfer his goodwill to STN through an employment or noncompete agreement if he were to leave, therefore "the value of those relationships should not be attributed to STN". The Court agreed with the estate's expert that economic charges of \$8 million to \$12 million over the projected period were appropriate to account for the significant value of Mr. Adell's personal relationships (goodwill), and that that the IRS expert's use of acceptable compensation for Mr. Adell of \$1.3 million was too low.

The Court ultimately determined the correct fair market value of the decedent's 100% equity interest in STN as of his date of death was the original date of death valuation prepared by the estate's expert of \$9.3 million. In addition, as the Court found the original value determined was appropriate, there was no need to address the substantial estate tax valuation penalty.

Parting Thoughts:

An interesting case where personal goodwill had a huge impact on the final value of a company. The fact that Mr. Adell's key relationships were personal and did not transfer to STN through an employment or noncompete agreement made a \$17 million difference in value. I have the feeling that the treatment/exclusion of personal goodwill, when appropriate, will become an area of further attention and scrutiny in the future.

Cubs Corner

I love the start of spring training and the wonderful feeling of hope that every fan experiences for his or her team at the beginning of each year. In my Cubs corner last January, I predicted that the Cubs record for 2014 would end up with a record of 70-92, and they ended up being slightly better at 73-89. Not a bad prediction though, only 3 games off!

This year will be much improved for the Cubs. It has been a busy off-season! The Cubs signed one of the



top baseball managers in the game in Joe Maddon (formerly with the Tampa Bay Rays). They signed one of the top free agent pitchers in the game in Jon Lester, and added some additional pieces such as Dexter Fowler to play center field and Miguel Montero and David Ross at catcher. The Cubs young talent from their farm system is starting to blossom, with guys like Arismendy Alcantara, Jorge Soler and Javier Baez expected to make some significant contributions towards the team this year. In addition, everyone is waiting for Kris Bryant, the 2014 minor league player of the year, to finally make his debut at third base (which is expected to happen by early May if not opening day). The future outlook for the Cubs is definitely the brightest it has been in a long time. The Cubs are now typically ranked as having either the #1 or #2 farm system in all of baseball according to most ranking sources. I have to say Theo Epstein & crew have done an amazing job of rebuilding the Cubs correctly to have sustained success over the longer-term.

What does that mean for 2015? Will there be playoffs in Chicago? Only time will tell, but I predict the Cubs will be much improved in 2015 but will still fall a bit short of the playoffs. They may have an outside shot at a wildcard spot, but right now I predict that they will win 86 games and have a record of 86-76. I think that their young talent needs a bit more time to mature and “learn the ropes” at the major league level. I could be surprised, though. There’s a chance that the young guys adjust to the major leagues quicker than expected, and they challenge for the division title and make some noise in the playoffs. Personally, I think that is a much more likely scenario for 2016, but you never know! That’s why I love this time of year.

Get out and enjoy some spring training baseball everybody!