



Valuation Insights

October 24, 2011

Volume 4, Issue 1

In This Issue

- John Mack Achieves the MCBA
- Court Case: Gallagher vs. IRS

Contact Us

John Mack, ASA, MCBA
623-340-6770
800-789-2401

john@mackbusinessappraisals.com
www.mackbusinessappraisals.com

Mack Business Appraisals, LLC
26956 N. 90th Lane
Peoria, Arizona 85383

John Mack Achieves MCBA Designation

In September of 2011, John was awarded the Master Certified Business Appraiser (MCBA) designation from the Institute of Business Appraisers. The MCBA is one of the highest professional designations awarded in the business valuation industry. It is awarded to individuals whose work has been widely accepted by clients and acknowledged by their most senior professional colleagues. The MCBA is a designation intended to indicate that the individual who has achieved this designation has achieved a high distinction of competence in his profession. As of today, John is only the 43rd individual in the United States that has earned this prestigious designation.



Estate of Gallagher vs. Commissioner of IRS

TC Memo Filed June 28, 2011, Opinion Issued October 11, 2011

The Facts:

Ms. Louise Paxton Gallagher (“Ms. Gallagher”) owned 3,970 units of Paxton Media Group, LLC (“PMG”), at the time of her death on July 5, 2004. As of July 2004, PMG was a publishing and media company that published 28 daily newspapers, 13 paid weekly publications, and a few specialty publications, and owned and operated a television station. Ms. Gallagher was the largest single shareholder in PMG at the time, holding 15% of PMG’s 26,439 outstanding units.



The estate filed Form 706 on September 30, 2005. The return stated the value of Ms. Gallagher’s units as \$34,936,000 or \$8,800 per unit, based on a July 12, 2004, appraisal of PMG’s units performed by PMG’s president and CEO, Mr. David Michael Paxton.

The IRS selected the return for audit and on June 13, 2007, the estate of Ms. Gallagher received a deficiency notice stating the fair market value of the PMG units owned by Ms. Gallagher was \$49,500,000, as of the date of her death.

The estate obtained an independent appraisal of the units from Sheldrick, McGehee & Kohler, LLC (SMK), which appraised the units at \$26,606,940. Prior to the start of the trial, the estate hired a second appraiser, Mr. Richard May, who valued the units at \$28,200,000,

or approximately \$7,100 per unit. Also before trial, the IRS hired Mr. John Thomson of Klaris, Thomson & Schroeder, Inc. (KTS) to perform an independent appraisal of Ms. Gallagher's units. Mr. Thomson determined the fair market value of the units to be \$40,863,000, or \$10,293 per unit.

The Court accepted both Mr. Thomson (an ASA with the American Society of Appraisers) and Mr. May (an appraiser who had previously performed several appraisals of publishing companies, including those who hold radio and TV broadcast assets) as expert witnesses in the case. Mr. Thomson valued the units using both a market approach and an income approach, and applied a 17% minority discount to the income approach and a 31% marketability discount to both approaches – concluding that the decedent's units had a fair market value of \$40,863,000. Mr. May, in contrast, relied primarily on an income approach and used the market approach only to establish a reasonable estimate of fair market value. Mr. May applied a 30% marketability discount to his income approach method – concluding that the decedent's units had a fair market value of \$28,200,000.

The Arguments and Findings:

The Court was asked to determine the fair market value of Ms. Gallagher's units as of her date of death, and in doing so, thoroughly examined both expert opinions. The estate and the IRS disagreed over the following items: (i) the date of financial information relevant to the date-of-death valuation; (ii) the appropriate adjustments to PMG's historical financial statements; (iii) the propriety of relying on a market based approach, specifically the guideline public company method, and the proper application of this method; (iv) the application of the income approach, specifically the discounted cash flow valuation method; (v) the appropriate adjustments to PMG's enterprise value; and (vi) the proper type and size or applicable discounts. Each argument is summarized below:

- i. Financials Utilized: Mr. Thomson utilized financial data gathered from PMG's internally prepared financial statements ending June 27, 2004, and financial information for comparable public companies for the quarter ended June 30, 2004. Mr. Thomson considered the information more accurate than an earlier date, despite the quarterly numbers were not published until one to two months after the valuation date. In contrast, Mr. May utilized internally prepared financial statements for PMG through May 30, 2004 – the latest statement published before the valuation date (July 5, 2004), and through March 28, 2004 – the latest quarterly data available before the valuation date for comparable public companies. Mr. May argued that a willing buyer and seller would be unaware of the later financial information utilized by Mr. Thomson as of the valuation date, and therefore it should not be utilized. The Court agreed with Mr. Thomson's use of PMG's June 27, 2004, financial information and the June 30, 2004, public company financial information, stating that the hypothetical buyers and sellers could have made inquiries as to the financial state as of the later date and would have been able to acquire such information. In addition, the Court also indicated that as the estate did not allege any intervening events between the valuation date and the publication of the June financial statements that would cause them to be incorrect.
- ii. Adjustments: Both appraisal experts made adjustments to remove nonrecurring items from PMG's historical financial statements to better represent the company's normal operations. Mr. Thomson made a single adjustment to subtract a \$7,895,016 gain on divested newspapers in 2000. Mr. May made several adjustments to PMG's financial statements, including three which drew objection from the IRS: (a) reduction of PMG's EBITDA in 2000 of \$7,900,000 for a gain on divested newspapers; (b) subtraction of a \$700,000 gain from an inherited life insurance policy in 2003, and (c) subtraction of a \$1,100,000 positive claim experience from PMG's self-insured health insurance in 2003. The Court accepted the gain recognition in 2000 because the IRS own expert also made the same adjustment but disregarded Mr. May's life insurance and self-insured health insurance adjustments as he provided no explanation as to why the gains were nonrecurring. In addition, Mr. May made several other financial statement adjustments which the Court disregarded because Mr. May provided no

explanation as to why they were made.

- iii. Use of Guideline Public Company Methodology: Both experts performed the guideline public company method. However, only Mr. Thomson placed any reliance on it in his final valuation conclusion. Mr. May indicated that reliance on this methodology is improper because no companies sufficiently similar to PMG existed to support the method's application. Mr. Thomson compiled a list of similar companies from a number of frequently used databases, and screened out companies that did not perform newspaper publishing as their primary function. Mr. Thomson then further pared down the list from 13 companies to four companies most similar to PMG in terms of size, and utilized a market value of invested capital (MVIC)-to-EBITDA multiple to estimate the fair market value of PMG. The Court determined that the four companies Mr. Thomson ultimately chose were not similar enough to PMG to be comparable with major differences in size, products and growth. The Court determined that Mr. Thomson's use of only four companies under the method with such large differences from PMG, was an improper use of the method, and disregarded it altogether.
- iv. Use of the Discounted Future Earnings Method (DCF): The Court stated that given the lack of public company comparables to PMG, the Court agreed that the DCF method was the most appropriate method to utilize to determine the value of Ms. Gallagher's units. Both experts utilized the method but disagreed on: (a) PMG's projections; (b) whether to tax affect PMG's earnings in calculating value; (c) cash flow adjustments; and (d) the appropriate rate of return. For (a), the Court decided to construct their own operating income projections in discounting PMG's net cash flow. First, the Court determined that Mr. Thomson's revenue growth projections were more persuasive and relied upon Mr. Thomson's revenue projections for their cash flow computation. Second, the Court disallowed an adjustment to account for higher industry newsprint costs as projected by Mr. May because of his inability to support this assertion. Third, the Court agreed with Mr. Thomson's operating margin analysis that estimated operating income at 39.5% of revenue as they did not have confidence in Mr. May's projections as they stated it was "based on improper earnings and newsprint cost adjustments". However, the Court modified Mr. Thomson's forecasted operating margin to include Mr. May's projected depreciation adjustment of 3.1% - which they found to be reasonable. Thus, the Court determined that PMG's projected operating margin was 36.4%. Finally, the Court also adopted Mr. Thomson's projection of other income (expense) of 0.1% of revenue - which they considered to be reasonable. For (b), Mr. May tax affected PMG's earnings by assuming a 39% income tax rate and also assumed a 40% marginal tax rate in calculating the applicable discount rate to utilize in the DCF. In contrast, Mr. Thomson disregarded shareholder-level taxes in projecting both the company's cash flows and computing the appropriate discount rate. The Court elected to not tax affect PMG's earnings and discount rate and stated "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". Furthermore, the Court stated that because Mr. May provided no further evidence for ignoring such a benefit, the Court elected to not impose a fictitious corporate tax burden on PMG's future earnings. For (c), the Court accepted the definition provided by Mr. May that net cash flow is defined as net operating income after tax plus depreciation and amortization expenses and minus working capital adjustments and capital expenditures except for the "after tax portion" as discussed in point (b) above. The experts disagreed on both the capital expenditures and working capital assumptions. The Court found Mr. Thomson's capital expenditure projection to be more reasonable - stating once again that Mr. May failed to support his projected increases in capital expenditures. Furthermore, the Court also found that Mr. Thomson's estimate that PMG's debt free working capital would remain at -2.5% of revenue throughout the projection period was more reasonable than Mr. May's due to his complete lack of support for the annual fluctuations purported by Mr. May (which is interesting because Mr. May actually provided projected income statements, balance sheets and cash flow statements which provided explicit detail as to why working capital would fluctuate. I

personally think that they just didn't understand this part of Mr. May's analysis). For (d), both experts used PMG's weighted average cost of capital (WACC) as the appropriate rate of return with which to discount PMG's expected future cash flow under the DCF method. The Court indicated that it is their usual preference NOT to use the WACC, but adopted it anyway because both parties utilized it in their analysis. Mr. Thomson computed a 10% WACC (assuming a 0% marginal tax rate), whereas Mr. May calculated a WACC of 12.3% (assuming a 40% corporate tax rate). The Court agreed that the tax rate should be 0% to be consistent with the pretax treatment of the cash flows. Regarding the cost of equity component of the WACC, Mr. May used a capital asset pricing model formula (CAPM) to derive a 13.5% cost of equity capital and Mr. Thomson used a buildup method to compute a 20% cost of equity capital. The Court agreed that the buildup method was the appropriate method to utilize when valuing closely-held companies, but disagreed with Mr. Thomson's calculation and performed their own calculation arriving at a cost of equity of 18%. Regarding the cost of debt capital component of the WACC, Mr. Thomson estimated PMG's pretax cost of debt at 6.6%, while Mr. May calculated a 5% average cost of debt. The Court was not convinced as to the accuracy of either expert's analysis, but decided to accept Mr. Thomson's calculation as his proposed higher cost of debt results in a lower present value of expected cash flows. Mr. Thomson assumed a mix of 75% debt and 25% equity, taking into account both PMG's current capital structure and the guideline companies' median capital structure. Mr. May assumed a mix of 15% debt and 85% equity, and provided little support for how he arrived at these percentages. The Court agreed that the 75% debt and 25% equity capital composition is appropriate. Accordingly, the Court's revised WACC computation using an 18% cost of equity also determined the appropriate WACC to utilize in the DCF was 10%.

- v. Adjustments to PMG's Enterprise Value: Both experts agreed that, under the DCF method, PMG's long-term debt must be subtracted from the present value of its future cash flows in order to arrive at the fair market value of PMG's units. They, disagreed, however, as to the amount of PMG's debt as of the valuation date. Mr. Thomson determined that the Company had \$243,602,413 of debt based on a June 27, 2004, balance sheet and Mr. May concluded that PMG had \$243,300,000 of net debt as of May 30, 2004. As the Court previously agreed with Mr. Thomson that the financial information through June 27, 2004, is acceptable, they also adopted Mr. Thomson's debt conclusion of \$243,602,413. Mr. May also adjusted PMG's value by \$900,000 to reflect its underfunded working capital whereas Mr. Thomson did not make this adjustment. The Court disregarded Mr. May's working capital deficit adjustment as they decided it was not persuasive. Mr. May also made adjustments to: (1) add \$12,847,000 to account for S shareholder tax savings on all future projected distributions in excess of tax distributions; (2) add \$44,262,000 to reflect the future value of the company's deductible goodwill, and (3) adding \$6,693,000 to account for the company's extra marginal debt tax shield. Mr. Thomson did not make any of these adjustments. The Court found that the S-corporation tax savings were already correctly accounted for by using a pretax discount rate and pretax cash flows. The Court disregarded all three of Mr. May's adjustments as he failed to convince them of their accuracy.
- vi. Applicable Discounts: Both experts agreed to the use of discounts in valuing Ms. Gallagher's PMG units. Mr. Thomson applied a 17% minority discount to his valuation result under the DCF method and then applied a 31% marketability discount to arrive at an aggregate minority interest value of PMG of \$267,000,000 as of the valuation date. Mr. May only applied a 30% discount for lack of marketability stating that a minority interest discount was unnecessary because the DCF methodology is derived based on cash flows that are assumed to accrue pro rata to all equity holders, therefore the resulting firm value is on a minority interest basis and needs no further adjustment to reflect a minority interest value. The Court determined that a minority discount was appropriate, but disagreed with Mr. Thomson's computation of the discount and concluded that a higher minority discount of 23% was appropriate. In addition, the Court determined that a 31% lack of marketability discount was also appropriate.

Ultimately, after consideration of all arguments, the Court determined that the fair market value of Ms. Gallagher's shares in PMG was \$32,601,640, not the \$34,936,000 as originally stated on the Form 706, which was a complete victory for the taxpayer.

Parting Thoughts:

This case was probably the most interesting valuation case that I have reviewed in the last several years. I found it fascinating the way the Court decided to prepare their own DCF analysis by analyzing the underlying DCF assumptions utilized by each appraiser and either selecting the assumption deemed most credible or determining their own assumption. I, like many appraisers, was disappointed in the fact that the Court still does not understand the need to tax affect S-corporation earnings or cash flows. However, it took the Court many years to start recognizing the tax associated with unrealized built-in gains associated with certain company assets, so it is likely going to be a similarly long process.

*****BREAKING NEWS - Supplemental Memorandum Opinion Issued October 11, 2011***

On October 11, 2011, the Court issued a supplemental memorandum opinion in order to correct a mathematical error in their computation of the value of the 3,970 membership interests in PMG. In the original decision, the value was calculated by computing the total present value of the expected cash flows for five years and added to that sum the present value of the terminal value component of the DCF. However, the Court utilized an incorrect present value factor of $(1+0.1)^6$ instead of the correct present value factor of $(1+.01)^5$.

The end result is that the Court re-determined the value of the 3,970 units at \$35,761,760, which is an increase of \$3,160,120 over the Court's original determination as of the valuation date. However, it is interesting to note that this end result is extremely close to the \$34,936,000 originally stated on the Form 706. So much for the Estate's refund!