



The Franchise Valuations Reporter



Our Expertise

Within the franchise, distribution and dealership context, we are experts in:

- Damages, Valuations & Expert Testimony
- Finance, Accounting and Tax
- Cyber Security



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We Write the Book

Franchise Regulation and Damages, the only treatise that covers damages in franchise disputes and valuations of franchises, is updated 3 times a year.

For more details, to see a Table of Contents or to place an order, go to the Wolters Kluwer Law & Business web page [here](#).

Valuations

Tax Affecting: The Issue Continues

In the opinion of this writer, the current issue of "tax affecting" is a false calculation looking for a justification to apply a fictional discount. The argument is that S corporations and other pass-through entities such as LLCs, LLPs and FLPs (and similar entities) should be valued normally according to some legitimate method such as a Discounted Cash Flow (DCF) and then discounted to value them as if they paid C corporation taxes even though they do not. The simple retort is that the entity does not pay the C Corporation tax because it is not a C corporation. Therefore, why should any entity which by law does not have to pay a C Corporation tax, be discounted to account for the C Corporation tax it does not and never has paid?

The history of the issue is outlined in the discussion in an eminent article[1] where the authors outline the treatment as follows:

- Stage 1 from 1958 to 1981 where maximum personal rates stayed at least 22% higher than corporate rates and therefore, S Corporations provided no real benefit. During this period discounted cash flow valuations regularly "tax affected" (i.e. supposed a corporate tax rate as a discount factor in the valuation) and the courts all agreed;
- Stage 2 from 1982 through 2002: When the benefit scale flipped indicating a cash flow benefit to the S form for tax purposes. And at this time a series of cases refused to allow "tax affecting" (i.e. a discount for hypothetical corporate taxes);
- Stage 3 from 2003 through the present: the issue has become questionable again.

The most recent resurrection of the matter was in the case of *Gross v. Commissioner*, T.C. Memo 1999-254,[2] a case which involved the gift tax due on shares given away in an S corporation which was a product franchise, a Pepsi-Cola bottler. The taxpayer's expert thought tax affecting was appropriate and the IRS's expert opined it was not. The Tax Court sided with the IRS holding that "tax affecting" was inappropriate because the "principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise." [3]

Subsequent to the Gross decision, the issue has come up frequently. It was addressed and dismissed in the following Tax Court cases:

1. *Wall v. Commissioner*[4]
2. *Heck v. Commissioner*[5]
3. *Adams v. Commissioner*[6]
4. *Dallas v. Commissioner*[7]

However, in one case the argument was accepted: *Delaware Open MRI Radiology Associates v. George J. Broder*. [8] But that was a Delaware Chancery case - not a Tax Court case - and it involved a "fair value" (an oppressed shareholder situation) rather than the normal "fair market value" definition. Nonetheless, since the Gross decision in 1999 four separate

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models have been devised by business valuator (all with multiple initials for credentials), for calculating this fictional discount.[9]

But now the issue is once again before the Tax Court in the case of *Cecil v Commissioner*[10] a case focusing on an Asheville, North Carolina, estate which is a popular tourist attraction, hosting 1.2 million visitors a year, which contains a winery and a 210-room hotel, the Biltmore. Notably, both experts in *Cecil* did tax affect the earnings of the Biltmore Company but the Tax Court may or may not accept their methodology. Although the case was argued in February 2016, it is still before the Court. We are awaiting a decision.

[1]Daniel Tinkelman, P.V. Viswanath & Glen M. Vogel, "Sub S Valuation: To Tax Effect, or Not to Tax Effect, Is Not Really the Question" *Tax Lawyer*, Vol. 65, No. 3. p. 555.

[2]Aff'd at 272 F.3d 333 (CA6 2001)

[3]Ibid p. 10

[4]T.C. Memo 2001-75 (Mar 27, 2001)

[5] T.C. Memo 2002-34, (Feb 5, 2002)

[6] T.C. Memo 2002-80 (Mar 28, 2002)

[7] T.C. Memo 2006-212 (Sep 28, 2006)

[8] Court of Chancery of Delaware, New Castle County C.A. No. 275-N, Decided: April 26, 2006.

[9] 1) The S corporation Economic Adjustment Model (SEAM) by Daniel Van Vleet ASA; 2) The Quantitative Marketability Discount Model (QMDM) by Christopher Mercer FASA, CRA, ABAR ; 3) another model put forward by Roger Grabowski FASA; and 4) a model put forward by Chris Treharne, ASA, MBA, BVAL.

[10]Case numbers 14639-14 and 14640-14

Expert Testimony: *Daubert* Challenges to Financial Experts

PriceWaterhouse Coopers Issues Annual Study

The annual [PriceWaterhouse study of challenges to financial expert testimony under Daubert](#) offers an extensive analysis of whether or not a *Daubert* challenge is appropriate to exclude an expert at the certification stage of a class action case. The question has not been definitively answered but the best guess is that a *Daubert* challenge at that stage is appropriate.

Recurring themes about financial experts cited in PwC study are:

1. **The Gatekeeper Function** - Daubert established judges as gatekeepers between juries and testimony offered by experts but often judges prefer that flaws be exposed through cross-examination at trial.
2. **Data Problems** - The use and misuse of data is a common stumbling block for financial experts who can be excluded for various reasons, including not providing sufficient support for calculations and not performing due diligence on data received.
3. **Qualifications** - Rule 702 states that experts may testify if they are qualified based on their knowledge, skill, experience, education, or training. But what constitutes acceptable qualifications can vary widely.
4. **Resubmissions** - In the past few years, courts have allowed experts to remedy challengeable issues in their original report by submitting a revised report.
5. **Legal Conclusions** - Financial expert testimony is often excluded if

the court considers it a legal conclusion.

IRS Underfunding Results in a Decline in Prosecutions

IRS Budget Increases Are Worth 4 to 10 Times Their Cost

A *New York Times* article entitled "[Why Steven Mnuchin Wants a Stronger I.R.S.](#)" points out that President Trump's new Treasury secretary knows that investing in the Internal Revenue Service

yields significant returns. He said as much during his confirmation hearings. And he's right: Every dollar spent on the agency returns \$4 in revenue for the federal government, and as much as \$10 when invested in enforcement activities.

Reduced Prosecutions of Tax Cheats Correlates to Reduced IRS Budget - IRS Criminal Investigation, FY 2016 Report

The IRS Criminal Investigation unit has cautioned that there is a correlation between the decline in staffing and tax collection. Between fiscal year (FY) 12 and FY16, the number of CI special agents declined by 447 agents and CI processed 485 fewer tax prosecution authorizations. Overall, CI reported that in FY 2016 it focused on tax-related identity theft, money laundering, public corruption, cybercrime and terrorist financing and added that it had a 92 percent conviction rate in FY 2016.

For fiscal year (FY) 2016, CI reported that its investigative priorities were:

- Abusive return preparer fraud
- Abusive tax scheme fraud
- Employment tax fraud
- Fraud referral program
- Identity tax fraud
- International tax fraud
- Questionable refund fraud

CI initiated 3,395 investigations and made 2,744 recommendations for prosecution in FY 2016. CI obtained convictions in 2,672 cases in FY 2016. Of the 3,395 investigations initiated in FY 2016, 1,963 were tax cases. The category of other financial crimes comprised the balance of investigations. This is obviously a result of starving the institution. As of September 30, 2016, CI had 2,217 special agents. This represented a decline of 4.3 percent to the number of special agents at the end of FY 2015. The number of professional staff personnel also declined. According to CI, over the past five fiscal years (FY 2011-FY 2016), staffing levels for special agents and professional staff have decreased by 19.1 percent and 21.7 percent, respectively.

Valuations: Recommended Reading

A Series on Valuations Using the Asset Based Approach

Robert Reilly, CPA, ASA, ABV, CVA, CFF, CMA, CBA, a managing director of Willamette Management Associates based in Chicago, has written a series of three articles on asset based valuations which we recommend. In the first article he distinguishes between the "asset" approach and the "cost" approach. In the second article he addresses the asset accumulation method

and in the third article in the series he addresses the adjusted net asset value method. He is a learned and long-practicing expert and the articles are informative.

Franchised Business vs Independent Business Ownership

[Nancy Lanard in her most recent newsletter](#) has addressed the long-standing but unprovable assertion that franchised businesses are far more successful than non-franchised businesses. She clarifies that the statistics do not support the claim and references the original 1980 U.S. Chamber of Commerce survey of approximately 2000 franchisors noting it has generally forfeit its status as gospel. She notes, "The problem with this data is that the data was never audited and also consisted of franchisors who volunteered to participate, not a random sampling. Unfortunately there has never been a formal study done of the success rate of a franchised business vs independent business ownership, so there really are no reliable statistics." She also notes, "There have been newer studies that indicate that defaults on SBA loans are high for both franchised business and independent business owners."