The IRS Says Executors Undervalued Prince's Estate by 50%

A recent article says the executor of the estate of Prince, the late world-famous rock star, and the Internal Revenue Service are currently locked in a fierce estate and gift tax dispute. The IRS argues the executor has seriously undervalued the estate, and the executors claim the IRS' calculations "are riddled with errors."

Prince (full name Prince R. Nelson) died in April 2016 of an overdose of fentanyl. The fact that he had no will has resulted in complicated and extensive probate proceedings and wildly fluctuating estimates of the worth of Prince's estate.

The executor of the estate is Comerica Bank & Trust, a financial services company headquartered in Dallas. According to the Star Tribune, Comerica filed a tax return in 2017, valuing the estate at $82.3 million. Last June, the IRS issued a notice of deficiency in which the agency claimed the estate was worth about double, $163.2 million, and owed an additional $32.4 million in taxes. The IRS assessed a $6.4 million accuracy-related penalty related to what it considered a "substantial" undervaluation of the estate.

The U.S. Tax Court's docket shows that, in August 2020, Comerica petitioned the court for review and, at the same time, asked for a trial. At issue are the value of Prince's real estate holdings and, most controversial, nontangible assets. The latter include ownership interests in music publishing, music compositions, and recordings. The article reports that at least one "deep-pocketed investor in music copyrights" has expressed great interest in acquiring the rights to Prince's music.

Besides his reputation as a brilliant musician, Prince became famous for keeping tight control over the release and use of his music and for enforcing his intellectual property rights aggressively. Case research shows that Comerica, whose role as executor includes acting as "fiduciary charged with monetizing and protecting the Estate's intellectual property for the benefit of [Prince's] heirs," seeks to continue along this path. It has set up the official Prince YouTube channel and has successfully litigated copyright infringement claims against those who have released unauthorized audio and/or video recordings of Prince performances.

In This Issue:

VMI Highlights:

A double congratulations to Katie Wilusz, ASA, CFA who earned her ASA (Accredited Senior Appraiser) accreditation. Katie was also appointed as co-chair of the Association for Corporate Growth's Young Dealmakers Committee.

Andrew Wilusz will be speaking to the Bucks County Estate Planning Council this February. His topic is, "Business Succession Planning."

If your firm is interested in having a VMI analyst give a business valuation and/or merger & acquisition related presentation, please contact Susan Wilusz at smw@valuemanagementinc.com. We are happy to make a live or virtual presentation.

Contact VMI

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From the Bench: 10 Warning Signals of Trouble With a Valuation Expert

It's always very informative and helpful to listen to judges talk about the valuation cases they hear. A panel of four judges recently shared their views of when they detect potential problems with appraisers when they are on the witness stand.

1. Suggestion of a level of precision that is not realistic.

An opinion of value down to the very last penny? A discount for lack of marketability taken out to three decimal places? Judges know that no appraiser can guarantee accuracy, but valuation experts who focus too much on math can fall into the "illusion of precision" trap that moves experts away from using judgment in the process.

2. Foundation based on judgment rather than available facts.

Gone are the days when an expert can merely rely on "my professional opinion." Often, millions of dollars are at stake when an input or assumption shifts, so the data must be current and the analysis in-depth.

3. Refusal to acknowledge an obvious error.

Everybody makes mistakes. In the judge's eyes, your credibility will suffer by attempting to support an error, so admit it quickly. Failure to acknowledge a minor error could affect the validity of the entire valuation. Once you've admitted the error, you can expect the following question: "How many other errors do you have in your report?" Rather than say "None" because another mistake may be found, the correct answer should be: "None that I know of."

4. Refusal to acknowledge alternative interpretation of the data or methods.

Judges are constantly puzzled whenever two highly qualified credentialed experts come up with such divergent values. Of course, different legitimate assumptions about the many variables and inputs in a business valuation can affect the opinion of value. The problem is when experts refuse to acknowledge that there are alternate ways to interpret data—then they give the perception of being a hired gun.

5. All 'judgment calls' go in the same direction.

Appraisers need to be cautious about their dealings with attorneys who can become overzealous and want to steer the valuation. Attorneys will hire experts they feel they can "shape," but judges can spot that type of advocacy. One judge made an interesting point: Experts who are most persuasive are those who "weave" advocacy into what he describes as "objective analysis." This lends itself to the judge adopting that expert's position "lock, stock, and barrel." An expert who sounds like just a mouthpiece for the attorney often winds up having his or her testimony totally discounted.

6. Approach and methodology dependent upon expert's 'side of the case.'

A sure sign of advocacy is if the approaches experts use change depending on which way the wind is blowing. Judges also take a dim view of experts who appear over and over again taking the same side and having the same opinion. What do judges do when they spot an expert advocating for the client instead advocating for his or her opinion? It depends on whether it's a jury trial or a bench trial. If it's a jury trial, the judge has to be very careful. Typically, there will be an objection by opposing counsel and then a conference at the bench to get the expert back on track. If it's a bench trial (no jury), the judge will admonish the expert to just stick to the facts and give his or her opinion.

7. Cannot clearly and simply 'tell the story.'

All too often, written valuation reports put too much emphasis on calculations and not enough on the narrative. Complicated facts need to be distilled into a simple story using bite-size morsels. A clear and convincing narrative must also be presented that ties to the numbers. One judge suggested to pretend that you are telling a story to a child, and focus on crafting a good beginning and ending—the middle will pretty much take care of itself.

8. Boilerplate, not case-specific, approach.

Attorneys will often say that, if a valuation report is too short, it's "lightweight," so the expert may be tempted to add a lot of boilerplate and padding. Judges know that certain sections of the report are prone to boilerplate, such as the industry and economic sections—a lot of pages of text and data that don't have much to do with the subject company. And, in today's pandemic environment, it's more important than ever to relate what's happening in the industry and economy to your subject firm.

9. Inability or unwillingness to connect the theory and case facts.

If you don't connect the dots between valuation theory and the facts of the case, the judge will interrupt you and say: "Please tell me what your analysis has to do with the facts!" The report may be a solid analytical work, but you must make sure that the facts connect with the analytical methodology and market data, and, foremost, tell the story in a clear and persuasive way.

10. Inability to admit or explain source of assumptions.

At the end of the day, it all comes down to the assumptions you make, which are based on personal experience and professional judgment. But you need to clearly explain the assumptions you are using in your various models. One good idea is to use an "assumption box" that can help guide users of the model to the key inputs driving it. At the end of the day, if your key assumptions are reasonable—sales projections, competitive situation, and the like—you'll have a good valuation. If they're not, you won't have a good valuation—it's as simple as that.

Sink or Swim: The New World of Virtual Testimony

Here to stay. Zoom meetings and similar technology-driven ways to avoid in-person conferences and trials are here to stay. This requires the attorney to ensure best use of the technology. Some attorneys have used consulting firms to tutor them on lighting, camera position, makeup, and other aspects related to presentation, so the attorneys and their clients can make a smooth appearance in court. At a minimum, attorneys or financial experts must test the technology before they appear at deposition or in court.

One suggestion is to be careful about camera position when doing a witness direct examination and a cross-examination of the opposing expert. You want to be able to be face-to-face with your expert and look at the opposing expert and convey your authority.

More stressful. In testifying virtually, there's a lot more to worry about, such as the technical glitches that can happen—and almost always do. Also, judges are getting impatient with the technology because it often takes longer to do things due to connectivity issues or delays with audio and video.

To avoid the technical issues, it's recommended that you have a practice session (or two) before the day of the hearing. Test your connectivity during the practice sessions and again on the morning of the hearing. Also, be sure to join the hearing at least 30 minutes prior to your scheduled time in case updates need to be performed before connection can occur. If you can, try to have IT troubleshooting backup in place during the hearing.

Additionally, adjust your surroundings so that you give the best appearance possible on camera. All too often, the wrong camera angles and terrible lighting that can make anybody on camera look bad. Set yourself up so that your background has very simple (organized) décor or a blank wall. Position the camera so it is above you, not below you, with the light coming from the front.

It is also important to remember that, although you may be attending a remote hearing, it is no less formal than a courtroom. All protocols should still be observed and proper courtroom attire should be worn. If you're wearing a jacket, sit on the end of it so it doesn't ride up your neck (an old trick TV newscasters use).

Some other tips to follow when you are "on the air":

- *Maximize your audio.* To minimize echo and feedback, audio can be connected through your phone. During the hearing, your audio should be muted unless you are required to speak. Don't forget to unmute yourself before you talk!
- *Be courteous.* Not only should you dress as if you are physically present in the courtroom, but you should also behave as if you are in the courtroom. This means that you should not use your phone, chew gum, eat, converse with others, get up and walk around, etc. When it is your turn, speak slowly and clearly. Do not interrupt others when they are speaking (especially the judge).

- *Eliminate the possibility of interruptions.* Put your phone on silent mode during the hearing or mute the sound on your computer audio. If there are family members or other individuals in your home, tell them to remain outside of the room, and warn them not to walk behind you or try to converse with you while you are "live" with the court. If you have pets, make sure they are located in another area and unable to cause interruptions during your appearance.
- *Watch what you say (type)!* If the chat feature is selected, remember that messaging may not be private—everyone in the meeting may be able to see it. Only use the chat feature if you are instructed to do so.
- *Stay calm.* Technology is not perfect, and there will always be glitches, even with technical run-throughs and practice. Remote hearings are expected to take longer than those being held in-person because of connectivity issues and delays with video and audio. It is a learning process for everyone, including the judges and attorneys.

Finally, it is sometimes easy to get distracted when sitting alone at your computer. Therefore, you need to take preventative measures to avoid that from happening.

FASB Seeks to Simplify Fair Value for Private-Company Shares

The Financial Accounting Standards Board (FASB) has issued a proposal drafted by the Private Company Council that would simplify how private companies determine the fair value of the shares underlying a share-option award on its grant date or modification date. The FASB noted that stakeholders had wanted a simplified approach for private companies because these firms typically do not have actively traded equity shares and so observable market prices for those shares do not exist. The FASB is proposing, as a practical expedient, to allow nonpublic entities to determine the current price of equity-classified share-option awards issued to both employees and nonemployees using the same valuation method prescribed by Section 409A of the Internal Revenue Code. The FASB said that it is expected that an independent appraisal will often be the method used by nonpublic entities electing the practical expedient in the proposal

COVID-19 Related Damage Claims

As the COVID-19 pandemic has shaped this year, there have been several business interruption rulings on lawsuits plaintiffs filed against insurers denying their claims for coverage. A summary is provided below.

***Rose's 1, LLC v. Erie Ins. Exch.*, 2020 D.C. Super. LEXIS 10 (Aug. 6, 2020)**

Ruling on the parties' motions for summary judgment, a D.C. federal court found the plaintiff restaurant owners failed to show that the D.C. mayor's COVID-19-related closure orders constituted "direct physical loss" to the property, as required under the existing business interruption policy.

***Diesel Barbershop, LLC v. State Farm Lloyds*, 2020 U.S. Dist. LEXIS 147276; 2020 WL 4724305 (Aug. 13, 2020)**

Similarly, in a business interruption case arising in Texas and resulting from the mandatory shutdowns to control COVID-19, a federal court dismissed the claims of plaintiff barbershops, finding they failed to show the requisite "accidental direct physical loss" to the premises as required for coverage and did not overcome the policy's express virus exclusion.

***Turek Enterprises, Inc. v. State Farm Mutual Automobile Insurance Co.*, 2020 U.S. Dist. LEXIS 161198 (Sept. 3, 2020)**

In a suit arising in Michigan related to mandatory COVID-19-related shutdowns, a federal court found the plaintiff chiropractic clinic failed to show the insurer breached its policy. The plaintiff did not demonstrate "tangible damage" to its property and failed to overcome the policy's express virus exclusion, the court said.

FASB Probes Fair Value of Restricted Equity Securities

The FASB has a project in initial deliberations titled Effect of Underwriter Restrictions on Fair Value Measurements. The objective of this project is "to reduce diversity in practice on measuring the fair value of equity securities that are subject to an underwriter lockup restriction." The FASB also decided to add a project to its research agenda to evaluate the effects of other types of sale restrictions on fair value measurements.

HSR Thresholds Decrease

The Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a (§ 7A of the Clayton Act or "the Act" or "HSR") requires that parties proposing certain mergers or acquisitions notify the Federal Trade Commission (the "FTC") and the Department of Justice (the "DOJ") before consummating the proposed transaction. The FTC's Premerger Notification Program was established to avoid some of the difficulties and expense that the FTC and DOJ encounter when they challenge anticompetitive acquisitions after they have occurred. Review of deals prior to closing enables the FTC and the DOJ to determine which acquisitions are likely to be anticompetitive and to challenge them at a time when something can be done effectively. The need for HSR notification is dependent upon the value or size of the acquisition ("size of transaction") and the size of the parties involved, as measured by their sales and assets ("size of person").

The size of transaction test considers the value of what is being transferred (voting securities, non-corporate interests and/or assets) in the proposed transaction and the value of what will be owned as result of the acquisition. The size of transaction test generally includes the value of what will be acquired plus the value of any interests in the acquired party that the acquiring party already holds. As presented in the chart that follows, the size of transaction threshold is $92 million (down from $94 million)[1].

The "person" in the size of person test refers to the ultimate parent entity of the buyer or seller. The size of person test measures the size of the parties involved by their respective levels of sales and assets as presented on their income statements and balance sheets in their last regularly prepared annual financial statements.

On February 2, the FTC announced its annual adjustments to the thresholds used to determine if certain mergers or acquisitions are reportable under the HSR. The new HSR thresholds, which are presented below, apply to transactions that close on or after March 4, 2021.

HSR THRESHOLDS

	SIZE OF TRANSACTION	SIZE OF PERSON	
		Small	Large
YEAR	$ Million	$ Million	$ Million
Original	50.0	10.0	100.0
2008	63.1	12.6	126.2
2009	65.2	13.0	130.3
2010	63.4	12.7	126.9
2011	66.0	13.2	131.9
2012	68.2	13.6	136.4
2013	70.9	14.2	141.8
2014	75.9	15.2	151.7
2015	76.3	15.3	152.5
2016	78.2	15.6	156.3
2017	80.8	16.2	161.5
2018	84.4	16.9	168.8
2019	90.0	18.0	180.0
2020	94.0	18.8	188.0
2021	92.0	18.4	184.4

For only the second time in history, the HSR thresholds have decreased[2].

Assuming no exemptions, (1) if the acquired interests are worth at least $92 million but less than $368 million (the size of the transaction test) ***and*** (2) one person has annual net sales or total assets with a value of at least $18.4 million and the other person has at least $184 million in annual net sales or total assets (the size of the person test), the proposed transaction triggers HSR notification and requires the parties to report it to the FTC and DOJ prior to completing the deal. Additionally, HSR notification and FTC and DOL reporting requirements are triggered prior to completing the deal for all transactions valued at more than $368 million (down from $376 million) and the size of person test is not applicable.

It is important for the parties of a transaction to be aware of HSR filing requirements because notifying the FTC and DOJ before completing a transaction will extend the time it takes to close the deal. After filing, the parties must wait to complete the deal until they receive approval. The waiting period is usually 30 days[3], during which time the FTC and DOJ review the proposed transaction. Also, parties to a proposed transaction should be aware that if a transaction is subject to HSR filing and the deal is closed prior to filing, the parties could be subject to hefty daily fines[4].

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[1]It should be noted that $92 million (as adjusted) is the first of five staggered "notification thresholds." The thresholds are designed to act as exemptions to relieve parties of the burden of making another filing every time additional voting shares of the same "person" are acquired.

[2]The Act requires an annual adjustment of thresholds based on changes in the U.S. gross national product for each fiscal year.

[3]The wait can be shorter or longer than 30 days. If early notification is requested by the parties involved in the proposed transaction, the wait can be less than 30 days; however, the FTC suspended early notification in 2021 until their work backlog subsides. The waiting period may be extended by issuance of a request by the FTC and/or DOJ for additional information and documentary material.

[4]While all thresholds were decreased in 2021, the FTC increased the maximum civil penalty for HSR violations to $43,792 per day (from $43,280 per day) and the filing fee of $45,000 remains the same for a transaction valued above $92 million and below $184 million.

ESOPs: Good for Employees

A recent article in the *New York Times* extols the virtues of employee ownership through employee stock ownership plans (ESOPs). As the *Times* article explains, ESOPs are a vehicle for owners to sell their company to their employees. ESOPs are particularly attractive to owners of family or small businesses who want to ensure that the company remains intact and its employees, who were instrumental to the flourishing of the company, are able to keep their jobs and build up a decent retirement account.

The article cites research from Rutgers University's School of Management and Labor Relations and the Employee Ownership Foundation that shows employee-owned companies have done better at retaining jobs for workers than nonemployee-owned companies during the COVID-19 crisis. Also, employees in companies that have an ESOP often are able to save more for retirement than employees with other retirement plans, including 401(k)s, because of the ESOP structure and also because employees as part-owners of the company are motivated to work extra hard.

The *New York Times* article quotes a wealth advisor saying that, given the potential tax benefits derived from the ESOP structure, "ESOPs may become more popular next year if the Democrats hit the trifecta and raise the capital gain rates to 39 percent."

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