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ISSUES + UPDATES SUMMER 2021

In Michael Jackson Case, Tax Court Dismisses IRS Expert's Revenue Projections as 'Simply Not Reasonable'

When Michael Jackson died, his image and likeness was besmirched, and yet, once competent executors took charge, they were able to make a lot of money for the estate in the immediate post-death years. The issue was to what extent this subsequent development could factor into the image-and-likeness valuation. In explaining his high valuation, the IRS' expert offered a theory of "foreseeable opportunities" that the U.S. Tax Court found unpersuasive *(Estate of Michael J. Jackson v. Commissioner,* 2021 Tax Ct. Memo LEXIS 74 (May 3, 2021)).

'Reasonably foreseeable': Michael Jackson died in 2009. The litigation in the U.S. Tax Court was over the fair market value of three contested assets at Jackson's death, including the value of Jackson's name and likeness. At trial, the estate established that, although Jackson was once an admired musician and superstar, at the time of death, his reputation was compromised in the wake of allegations of child sexual abuse and a criminal trial of which he was acquitted. He accumulated serious debt and was at risk of bankruptcy.

The estate's image-and-likeness experts found this asset was worth about $3 million. In contrast, the IRS' expert, also using a discounted cash flow analysis, valued this asset at over $161 million. The court said the expert took a "wildly different approach," which, among other things, resulted in much higher revenue projections. Rather than using income Jackson had earned before his death from his image and likeness as a starting point, the IRS' expert considered "foreseeable opportunities," i.e., opportunities that the expert believed were reasonably expected at the time of death and would create revenue attributable to Jackson's image and likeness. They included themed attractions and products, branded merchandise, a Cirque de Soleil show, a film, and a Broadway musical.

The court rejected the analysis "as fantasy." Among its flaws was the inclusion of unforeseeable events. The valuation date, the court noted throughout its long opinion, was the time of Jackson's death. "Foreseeability can't be subject to hindsight," the

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VMI Highlights:

Ed Wilusz spoke at the NCEO Annual National Employee Ownership Conference. His topic was "Preparing Forecasts the Trustee Will Love."

Greg Kniesel spoke at The ESOP Association Association National Conference. His topic was "Basic ESOP Valuation."

Ed Wilusz was recently appointed Chairperson of the Mother of Mercy House. It is a faith-based charitable organization serving the Kensington section of Philadelphia, a neighborhood suffering with poverty, violence and addiction.

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.

court said. However, a court may consider subsequent events "to the extent that they were reasonably foreseeable at the decedent's death." The court found here the opportunities the IRS' expert designated as foreseeable "bear some considerable resemblance to deals the Estate, under its competent management, did do in the years after Jackson died." Although the IRS expert "carefully said he didn't rely on events after Jackson's death in his valuation, he did look at them to assess the reasonableness of his projections," the court noted.

In reviewing the claimed "foreseeable opportunities," the court found four of the five revenue streams included in the IRS valuation were unforeseeable at the time of death. The court said the same problem "lurk[ed] everywhere in our analysis of the value of Jackson's image and likeness—his poor reputation other than as an entertainer." In the last 10 years of his life, Jackson received almost no revenue from his image and likeness "despite being one of the most well-known persons on Earth." According to the court: "Any projection that finds a torrent of revenue, and not just a trickle, from such a man's image and likeness—especially one who in the last two years of his life was so unpopular he did not even have a Q score—is simply not reasonable." The IRS' expert ignored "this rather severe limitation."

The court assigned a value of approximately $4 million to this asset.

Fiat Chrysler Brand Portfolio Valued Using 1% Royalty Rate

The portfolio of Fiat Chrysler brands is worth EUR 10.4 billion based on a preliminary valuation using a 1% average royalty rate, according to a white paper from MARKABLES. PSA Peugeot recently acquired Fiat Chrysler Automobiles, and its assets were valued in a purchase price allocation. The white paper notes that the valuation (which is still preliminary) makes Fiat Chrysler the 12th most expensive brand portfolio ever changing hands in an acquisition. The brands include Fiat, Chrysler, Dodge, Jeep, Ram, Alfa Romeo, Lancia, Abarth, Maserati, and SRT. The 1% average royalty rate "is in line with the royalty rate applied in 2011 when Fiat took over Chrysler," the MARKABLES paper says. "The royalty rate might seem surprisingly low, considering the awareness and reputation of famous passenger car brands. However, it reflects weak profitability in the consumer vehicles sector, overcapacities, technological changes and environmental issues." MARKABLES is a provider of data designed to support the valuation of IP assets.

COVID-19 Just a Speed Bump in Hot M&A Market, Say Speakers at Transaction Advisors Forum

A year ago, you would not have thought M&A deal activity would reach an all-time high, but that's just what has happened, say speakers at the M&A Strategy Forum on April 30, hosted by the Transaction Advisors Institute. Speakers included corporate development leaders, in-house M&A counsel, board members, and private equity investors. Here are some interesting takeaways from the other sessions:

- COVID-19 has not triggered any fundamental changes to the M&A playbook, just a few tweaks to the process, such as how to address events such as the pandemic between the time a deal is made and when it closes;
- In a virtual world, it's more difficult to assess whether the target's culture will successfully mesh with the acquirer—being on-site gives a better feel for this;
- Retaining talent in the target is not an issue in the short term, but, after three years, a significant amount of the acquired staff takes off, which impacts long-term value creation, especially in a relationship-type business;
- If a target's business is rooted in software, the integrity of that software in terms of technology compliance and cyber security is a key part of the due diligence process; and
- The heightened regulatory enforcement that began before the Biden administration is just the beginning of a trend, and challenges to mergers will continue to escalate.

Data Breaches Threaten Brand Values, Says Study

A recent study from Infosys and Interbrand analyzes the maximum risk of brand value loss in case of data breaches. For the "100 Best Global Brands" ranked in the 2020 Interbrand list, the maximum risk amounts to a loss of 11% of brand value. "While this figure doesn't look dramatic, it can translate to more than 100% of net annual income, depending on sectors," the folks at MARKABLES said in a statement. The authors of the study suggest that brand owners should re-evaluate "hygiene" aspects of customer experience, such as cybersecurity. MARKABLES adds that brand owners should establish the value of their brands, quantify the risk they are exposed to, and rethink their approach to both risk avoidance (cybersecurity) and risk management (brand insurance coverage).

Caesars Entertainment Sues Over COVID-19-Related Economic Damages

On March 19, Caesars Entertainment joined the long list of businesses that have filed lawsuits against their insurance companies for refusing to pay business interruption losses stemming from COVID-19-related government shutdowns of economies across the nation and world. Whether Caesars, which asserts that losses its various business entities incurred may exceed $2 billion, succeeds where a lot of other plaintiffs have failed will be worth monitoring.

The suit lists about 60 insurers as defendants. Caesars claims it bought $3.4 billion of all-risk insurance for business interruption losses "precisely to cover catastrophic situations at its properties." Regardless, insurers have refused to pay for Caesars' "devastating losses," Caesars says. Therefore, it decided to sue. Caesars says the insurers "are keenly aware of Caesars' rights to coverage for its losses under the policies at issue here, and have increased premiums accordingly and inserted new exclusions in subsequent policies."

Caesars filed suit in District Court, Clark County, Nevada. The complaint points out that, prepandemic, Caesars employed more than 79,000 people. "As of the date of filing, Caesars has been forced to significantly reduce its pre-COVID-19 workforce." The complaint discusses the economic impact of the virus and the "crippling" government-mandated closures on the economy in Nevada, and particularly Las Vegas.

"Nevada's labor market has been especially hard hit," the complaint says, noting Caesars had to shut down properties in March 2020 based on orders of the gaming control boards and other civil authorities. Since then, other orders varying by degree and location have continued and "substantially impacted" the company's properties and businesses, the suit asserts.

Caesars' complaint argues the virus contaminated all the grounds and, in this way, caused physical damage to the property. It talks about "the tangible, physical presence" of the coronavirus on surfaces or in the air of its properties, which "alters, damages, and renders the physical property unfit and unsafe for its intended use."

"Caesars fortunately had the foresight to purchase broad insurance from the Defendant All Risk Insurers," the complaint says. Caesars notes that this type of comprehensive coverage "is very expensive. Caesars paid over $25 million in premiums for the policy year at issue."

The complaint also points out that most "of the highly sophisticated insurance companies" issuing the all-risk policies did not include a virus exclusion for 2020. The complaint says the lawsuit specifically excluded insurers that included the exclusion from the defendant list.

Tax Court Allows for 'Slight' Discount for Lack of Control for Majority Interests in Real Estate Holding Companies

***Estate of Warne v. Commissioner, T.C.* Memo 2021-17; 2021 Tax Ct. Memo LEXIS 22 (Feb. 18, 2021)**

In a gift and estate tax dispute, the estate and Internal Revenue Service agreed to apply discounts for lack of control and marketability to the majority interests in a number of real estate holding companies. The U.S. Tax Court noted that, in prior decisions, the court found no discount for lack of control applied. However, given the parties' agreement, here the court said it would apply a "slight" or "low" discount. The IRS claimed a 2% discount; the taxpayer claimed 5% to 8%. The court found a 4% discount for lack of control was appropriate.

Tax Court Deals Another Blow to Cannabis Dispensaries

In recent years, numerous cannabis businesses that are legal under state law have unsuccessfully challenged section 280E of the Internal Revenue Tax Code, which prohibits tax deductions for a business that "consists of" trafficking in a controlled substance. A recent U.S. Tax Court ruling against a California medical cannabis dispensary *(San Jose Wellness v. Commissioner,* 156 T.C. No. 4 (Feb. 17, 2021)) continues the trend.

280E's broad sweep: The taxpayer was a medical cannabis dispensary licensed by the city of San Jose, California. The business also sold noncannabis items such as T-shirts, pipes, and batteries, and it offered acupuncture, chiropractic, and other holistic services. The business claimed deductions for business expenses, depreciation, and charitable contributions for various tax years. The Internal Revenue Service disallowed all the deductions under I.R.C. section 280E. The taxpayer petitioned the Tax Court for review.

Medical cannabis, although legal in many states, under federal law, has been classified as a Schedule I controlled substance. Generally speaking, federal law preempts state law. For purposes of section 280E, dispensing cannabis qualifies as "trafficking" in a controlled substance.

The taxpayer argued that section 280E does not preclude deductions for depreciation and charitable contributions. Depreciation, the taxpayer claimed, was not "paid or

incurred during the taxable year"; further, the charitable contributions were not made "in carrying on" a trade or business. Despite being aware of Tax Court precedent to the contrary, the taxpayer (for purposes of appeal) also claimed none of the expenses it deducted should be disallowed under 280E because the taxpayer's business did not "consist of" trafficking in controlled substances.

The Tax Court rejected all the arguments. "[T]he text of section 280E sweeps broadly to preclude a deduction for '*any amount* paid or incurred during the taxable year in carrying on any trade or business … [that] consists of trafficking in controlled substances,'" it said, with emphasis. Further, it cited a number of relatively recent Tax Court decisions that found that "section 280E means what is says—no deductions under any section" of the code for businesses trafficking in a controlled substance.

The court noted it had dismissed the argument that the taxpayer's business did not "consist of" trafficking in a controlled substance because it also sold noncannabis items and provided various services in the 2018 *Patients Mutual* case. There, the court ruled against another California dispensary that claimed expense deductions should not be disallowed under section 280E.

As for the taxpayer's claim that depreciation is not "paid or incurred during the taxable year," it was "foreclosed by the Code and Supreme Court precedent," specifically the Supreme Court's 1974 decision in *Commissioner v. Idaho Power*. The Tax Court said, *Idaho Power* "leaves no doubt" that depreciation represents an "amount paid or incurred during the taxable year." Therefore, "section 280E applies by its express terms to [the taxpayer's] circumstances." Also, the requirements of section 280E applied to charitable contributions, the court found.

Survey Says: Half of M&A Deals Disputed

Grant Thornton's February 2021 M&A Dispute Survey shows that accounting-based deal disputes are common. In its survey of M&A professionals involved in approximately 1,300 transactions occurring in 2020, nearly half the deals ended up with an accounting dispute. Fortunately, it was reported that most of the disputes were resolved before further steps were needed.

Vague language and purchase price adjustments are identified as key factors. Working capital and earn-out issues are cited as the main culprits for deal disputes, followed by disagreements over debt, representations and warranties (insurance and between parties), and cash.

Court Of Chancery Adopts Deal Price, Adjusting for Synergies and Tax Savings

In a statutory appraisal action, the Delaware Court of Chancery recently adopted the deal price minus synergies as the best indicator of fair value. *In re Appraisal of Regal Entertainment Group.,* 2021 Del. Cha. LEXIS 93; 2021 WL 1916364 (May 13, 2021), the court found one further adjustment to account for the change in the target's operative reality between the date of signing and closing of the merger also was necessary. This is one of those increasingly rare cases in which the petitioners, as shareholders of a public company, obtained a price that was slightly higher than the merger consideration.

Background: The petitioners owned shares in Regal Entertainment Group (Regal). In February 2018, Cineworld Group (Cineworld) acquired Regal by way of a reverse triangular merger. The merger consideration was $23 per share. The petitioners owned shares in Regal. Regal's board approved the merger agreement in early December 2017. In late December 2017, then-President Trump signed the Tax Act into law. Most changes took effect starting Jan. 1, 2018. The merger closed in February 2018.

Two required adjustments: The court looked to the deal price and found the sale process was sufficiently reliable to consider it the best evidence of Regal's fair value as of the signing of the merger. However, this was a synergistic transaction. Under the applicable law, the court must determine the value of the company as a going concern, meaning the court must deduct any value derived from the expectation of the merger. The buyer, Cineworld, undertook detailed analyses as to the synergy value it could derive from the merger. Ultimately, this value was important to Cineworld's financing. Much of the court's analysis deals with how to estimate the value of synergy and how much of that value to allocate to the seller.

The court noted that, here, there was evidence that the buyer had not overpaid for the target but had allocated some of the anticipated synergies to the seller. There also was contrary evidence that the buyer did not contemplate synergy value from the deal. The parties apparently did not bargain over synergies. Cineworld's trial expert said he could not determine how the parties split synergies. He relied on a 2018 Boston Consulting Group (BCG) study that found that sell-side stockholders of the target company typically capture about 54% of synergies.

The court acknowledged it faced a less-than-optimal record and unsettled precedent as to what is necessary to prove a synergy allocation. It decided the 2018 study was "the best tool available for an imprecise task." If the

amount of the synergy value was $6.99, based on the study, the seller side captured 54% of it. Therefore, the court said, $3.77 must be subtracted from the deal price as synergy value.

A second, upward, adjustment was necessary as a result of the 2017 Tax Act, the court found. It noted that the applicable appraisal law requires fair value be measured by the operative reality of the company at the close of the merger. Both sides agreed that the company's value changed as the new Tax Act lowered corporate taxes to 21%. The court noted Regal's lowered tax rate reduced the amount of financial savings that the buyer could achieve. After the Tax Act, those financial savings were part of the value available to Regal in its operative reality as a stand-alone entity, the court said. It added $4.37 per share to the deal price minus synergies. As a result, the court decided the fair value of the petitioners' shares was $23.60 versus the $23 deal price.

ACT NOW or (Potentially) PAY LATER!

Given the uncertainty of when the new administration's tax plan will be effective and the new rates implemented, now is a good time for your clients to reexamine their estate tax plans.

The key points of President Biden's proposed tax changes to consider when doing estate planning are:

- Wealthy families could face combined tax rates of as much as 61 percent on inherited wealth, according to a recent analysis.
- The combined tax rate would be the highest in nearly a century, according to the tax policy research group.
- Reduce the current $11.7 million federal estate tax exemption to $3.5 million.
- Limit total annual exclusion gifts to two-times the amount of the annual exclusion.
- Reduce the current $11.7 million lifetime gift tax exemption to $1 million.
- Limit generation-skipping transfer trusts to a term of 50 years.

President Biden's tax plan also proposes to nearly double the top tax rate on capital gains and eliminate a tax benefit on appreciated assets known as the "step-up in basis."

Proper Damages Measure Is Lost Profits Calculation, Not DCF-Based Loss Analysis

***Precision Kidd Acquisition, LLC v. Pass,* 2020 Pa. Super. Unpub. LEXIS 3103 (Oct. 1, 2020)**

This Pennsylvania appellate court decision (unpublished) includes an informative discussion of how to measure damages arising out of a merger in which the seller allegedly failed to inform the buyer during negotiations that one of its bigger customers, Snap-On Tools (SO), had terminated a supply contract. The buyer (appellant) argued the proper measure of damages was the difference between what the company was worth as represented by the seller and what it actually was worth upon the purchase. The trial court found the buyer's damage determination was not credible and awarded lost profits based on the seller's expert testimony.

A nonjury trial followed in which the trial court found there was a breach of contract and awarded the buyer $36,000 in damages (and over $384,000 in attorney's fees).

The buyer's expert said the "principal concept of [his damages] analysis" was the value of the seller with the SO agreement intact minus the value of the company without the SO agreement in place. He said the best indicator of value with the SO agreement was the agreed-upon final purchase price, $11.4 million.

He said he used a discounted cash flow analysis to determine the value of the company without the SO agreement, which he found to be $9.3 million. By his measure, damages were $2.1 million.

The seller's expert agreed with counsel that the opposing expert improperly "treated this contract the same as this whole enterprise in terms of risk and the value of that contract."

The seller's expert also noted that the buyer did not actually pay $11.4 million, but only $7.4 million because the merger consideration was reduced by $4 million for an underfunded pension liability account.

He said, for his analysis, he considered that the assets were greater than the purchase price and this did not change with the termination of the SO contact. He found there was no way to determine a decrease in value because of the SO relationship and, therefore, looked at a "simple lost-profits calculation."

He presented to the court three alternative analyses that found the company had lost profits incrementally from $36,000 to $109,000.

The trial court said it did not find the testimony of the buyer's expert credible. The plaintiff (buyer) was unable to prove $2.1 million in damages with reasonable certainty

"where it solely relies on incredible expert testimony." The court said it "will not rewind the clock to determine what [the buyer] would have paid for the Company based on [its expert's] overstated valuation."

But the court said it recognized that SO was able to terminate its contract within 120 days of notice. "Assuming [the buyer] knew of the termination at the time of the transaction, [the buyer] would be entitled to 120 days of profit[s] from its business with Snap-On." The court said it would award $36,000 in damages based on the seller's expert's lost profits analysis. This amount, the court said, was a "fair and reasonable estimate of lost profits suffered by [the buyer] for those 120 days."

The appellate court was not persuaded. It noted the trial court found that the buyer's expert presented a damages calculation that was "inflated and flawed in multiple respects" and therefore declined to rely on the expert's testimony. Considering the valuation evidence before the trial court, it did not err in failing to award damages based on the measure and analysis the buyer proposed.

The appellate court upheld the trial court's damages finding, but it remanded for reasons related to the trial court's fee award.

KPMG on Venture Capital Funding

"Despite the COVID-19 crisis, global venture capital funding increased 4.0% year over year to $300 billion in 2020," says *KPMG's Quarterly Brief—International Valuation Newsletter* for the second quarter of 2021. The funding growth was attributable to industries such as healthcare, education, finance, retail and entertainment, which migrated their service offerings online as a result of the global pandemic.

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