VALUE MANAGEMENT INC.

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ISSUES + UPDATES

SPRING 2022

Dealmaking Expectations for 2022

According to a recent survey of Association for Corporate Growth members, 80 percent of respondents said their outlook on M&A activity for 2022 remains positive. The backlog of deals that didn't launch in 2020, coupled with expected changes to tax rates and attractive valuations, were some of the factors for unprecedented activity in 2021. 2021 was also fueled by the fact that the world shut down for a long time. The market didn't start picking back up until August or September of 2020, so there was a lot of pent-up demand.

Some of the elements that drove a particularly busy year in 2021 will still be around in 2022, but will be less pronounced. Excess dry powder, more companies in line to be sold and sellers looking at high valuations garnered by competitors all continue to be motivating factors for a strong pipeline. The new threat of increased tax rates (see article on page 2) should also increase activity.

Market players are now watching another potential change: the likely rise of interest rates that will impact the cost of debt for leveraged buyouts. A rate hike will mean that lenders won't be able to offer as much leverage on deals, which could directionally impact valuations.

Some of the industries that were hot in 2021, like technology, healthcare and services, will continue to be attractive in 2022. Additionally, manufacturing, pharma, and consumer products and services are expected to see increased activity.

Furthermore, potential consolidation through M&A may occur as companies seek to protect their supply chains from future disruptions. Eighty percent of middle-market companies are currently experiencing supply chain challenges. Companies have faced obstacles in sourcing, manufacturing and delivery, and many have had to fundamentally rethink their supply chain and logistics strategies.

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VMI Highlights:

We are happy to announce that Mark Winger, ASA, CFA, CPA/AVA has joined VMI as a Manager. Mark has over 20 years of valuation experience. Please join us in welcoming Mark to the VMI family!

Congratulations to our intern, Kwahmyre Barbour, who received the Black Excellence award from the Black Student Union at Fairfield University. Kwahmyre will be returning for another internship with VMI this summer, along with our other interns Nic Ertz and Max Lesoine. We are excited to have them working with us this summer!

If your firm is interested in having a VMI expert give an in-house or virtual presentation on business valuations and/or merger & acquisitions, please contact Susan Wilusz at smw@valuemanagementinc.com. We are happy to make a live or virtual presentation.

Ownership Transition in the Middle Market

There are an estimated 200,000 middle-market businesses in the U.S., which represent about one-third of private-sector GDP and close to 50 million jobs, according to the National Center for the Middle Market. The U.S. middle market is defined as companies with annual revenues between $10 million and $1 billion. Many of these middle-market businesses are privately owned and managed by the founding entrepreneurs along with their family members. More than three-quarters (77%) of these firms have either experienced an ownership transition in the past five years or expect to transition within the next five years.

Proposed Tax Law Changes Could Impact Company Valuations and Estate Planning

On March 28, President Biden released his budget for Fiscal Year 2023, which begins October 1, 2022 and ends September 30, 2023. It includes several items that were part of the Build Back Better legislation introduced in Congress late last year, as well as notable new tax proposals.

The following is not an all-inclusive list, but includes some of the more relevant income and transfer tax provisions:

- Increase the top marginal tax rate to 39.6%, effective for tax years beginning after 2022.
- Tax long-term capital gains and qualified dividends of taxpayers with taxable income of over $1 million at ordinary income tax rates, effective for gains recognized after the date of enactment.
- Treat transfers of appreciated property by gift and at death as taxable dispositions, effective for transfers made after 2022. Certain exclusions would apply, such as for transfers between spouses.
- Raise the corporate income tax rate to 28%.
- Tax on stock buybacks (potentially 1%), and a prohibition on executives selling shares in the years (potentially three years) after a stock buyback.
- Impose a 20% minimum tax on the income, including unrealized gains, of taxpayers with a net worth of over $100 million, effective for tax years beginning after 2022.
- Impose minimum term and gift requirements on grantor retained annuity trusts (GRAT), effective to all trusts created on or after the date of enactment.
- Treat exchanges between a grantor and an irrevocable grantor trust as taxable transactions, effective for all transactions occurring on or after the date of enactment.
- Treat the payment of the income taxes of a grantor trust by the grantor as a gift, effective for trusts created on or after the date of enactment.
- Limit the duration of the generation-skipping transfer (GST) tax exemption, effective to all trusts subject to the GST tax on or after the date of enactment.
- Require consistent valuation of promissory notes, effective for valuations on or after the date of introduction.
- Tax carried interests as ordinary income, effective for tax years beginning after 2022.
- Cap the deferral of gain from like-kind (1031) exchanges to $500,000 per taxpayer, effective for exchanges completed in tax years beginning after 2022.
- Limit a partner's deduction in certain syndicated conservation easement transactions, generally effective for contributions made in tax years ending after December 23, 2016.
- Limit the use of donor-advised funds to avoid the private foundation payout requirement, effective after the date of enactment.

These are only proposals by the Biden administration. It is not clear if any of them currently have enough support in Congress to be introduced in a bill.

Cyberattacks Worry Middle-Market Companies

Middle-market executives cited cybercrimes as a growing concern. According to the FBI

2020 Internet Crime Report, the agency received a significant increase in complaints in 2020 related to internet crimes. The more than 790,000 complaints that year jumped by 300,000 compared to 2019. Losses in 2020 due to internet crime were more than $4.2 billion.

The top cybercrimes reported were phishing scams, non-payment/nondelivery scams and extortion. COVID-19 fueled pandemic-related cyberscams, resulting in more than 28,000 complaints that targeted individuals and businesses.

The most costly type of complaint revolved around business email compromise schemes. More than 19,000 complaints accounted for about $1.8 billion in losses.

Another concerning risk for middle-market companies was remote work. Before the pandemic, IT departments could be relatively sure that company data would be secure as employees used company computers in their office or at their workstation, but remote work has opened up a new avenue for cybercriminals to access data through unsecured systems and internet access.

New IRS Trap for GRATs When There Is a Merger Pending

CCA 202152018, the IRS Office of Chief Counsel Memorandum

The IRS Chief Counsel office recently released a memorandum, which comes to two primary conclusions. First, under the fair market value standard, the hypothetical willing buyer and willing seller of a company would consider a pending merger when valuing stock for gift tax purposes. Second, the retained interest is not a qualified annuity interest under § 2702 of the Internal Revenue Code (Code) because the donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

The first conclusion is not necessarily new as there is prior case law to support this conclusion. As with many, if not most, valuations, this issue often comes down to whether the pending merger was known or knowable at the date of the valuation. The hypothetical outlined in this memorandum indicates that, while the transaction had not closed at the date of the gift to the two-year GRAT, the transaction would have been known or knowable. As a result, the stock donated to the trust was significantly undervalued in the appraisal used for the gift. Thus, the first conclusion is that the merger should have been taken into account and was not.

The second conclusion is the one that's creating heartburn for some estate planners. Given the first conclusion of the memorandum, the second conclusion says that the retained interest is not a qualified annuity interest under Sec. 2702 of the Code. Thus the entire value of the interest donated to the trust would be a taxable gift at the date of transfer.

The Jury Verdict Cannot Stand Because It Was Based on an Expert's Incompetent Report

***State Route 00700, Section 21H v. Bentleyville Garden Inn, Inc. (In re Condemnation by DOT),* 2021 Pa. Commw. LEXIS 562; 2021 WL 4483462 (Oct. 1, 2021)**

The jury's verdict in the eminent domain trial could not stand because the jury relied solely on the valuation of the Pennsylvania Department of Transportation's (PennDOT) expert, "which was incompetent."

Background. In 2015, PennDOT filed for a partial taking of condemnee's 5.902-acre property for a new exit ramp for I-70. The taking was 1.014 acres for the ramp and 0.856 acres for construction. The project was completed in November 2018. "On March 16, 2015, PennDOT paid condemnee $286,915 as what it considered to be just compensation for the partial taking of condemnee's property." The full property had a Best Western Hotel on it.

In 2017, the condemnee filed for a board of viewers, which the trial court approved. The parties provided expert testimony on the amount of just compensation owed to condemnee. The board of viewers awarded condemnee $2,908,000. PennDOT appealed the award as excessive. On Oct. 21, 2019, a trial was held for three days to determine the merits of PennDOT's appeal. The condemnee provided testimony from an expert in the valuation of hotel properties, and a certified real estate appraiser. PennDOT offered testimony from four witnesses.

Dr. Gosai, president and owner of the condemnee, testified that, as a result of the two-year construction and now closeness (by 150 feet) of the ramp to the hotel, the post-construction occupancy rate of the hotel had dropped to half of what it was preconstruction. After construction began, the average daily rate for the hotel dropped from $100 per night to $80 per night. Revenues for the condemnee's hotel were depressed, and competitors revenues had increased. "[The general manager for the hotel] testified that in 2013 and 2014, the hotel was running at approximately 90% occupancy. After PennDOT's taking, occupancy declined to approximately 30% to 40%."

The condemnee's hotel expert testified that the property was ideal for a hotel. He also did a study in 2014 that predicted a significant decline in the hotel's average daily rate, which actual experience has largely confirmed. The condemnee's expert real estate appraiser testified that the reconfiguration of the interchange impacted the value of the property in several ways. He considered these factors in his post-taking valuation of the real estate. He valued the land PennDOT took at $359,600. He valued the entire property using the income approach at $5,614,000 before taking and $3,065,000 post-taking for indirect damages of $2,549,000 plus the $359,600 for total damages of $2,908,000.

PennDOT's environmental planning expert did a noise study and determined that the property would not require sound remediation as a result of the construction and post-construction. PennDOT's expert real estate appraiser determined the value of the taken property at $355,000. He determined that there was no loss in value of the hotel property before and after the project construction. He did value the entire property at $5,702,000 and $5,437,000 after-taking, a difference of $355,000. He used the hotel's pre-taking revenues to value the hotel both before and after the taking.

Jury verdict. The jury awarded $355,000, PennDOT's expert's amount, which the condemnee, in a post-trial motion, argued was grossly inadequate and did not include any post-damages to the fair market value of the property caused by the proximity of PennDOT's project. The motion was denied.

The trial court recognized a decline in occupancy had occurred but reasoned it was due to a decline in the oil and gas industry. The trial court also noted that the noise expert for PennDOT opined that the ramp reconfiguration did not impact the noise level at the hotel. The trial court also reasoned that the jury chose to credit the just compensation PennDOT's expert proposed.

Appeal. "On appeal, condemnee raises one issue for our consideration, i.e., that the trial court erred and abused its discretion in denying its post-trial motion for judgment notwithstanding the verdict or for a new trial." Condemnee argued the jury verdict was unlawful for two reasons: (1) PennDOT's expert's opinion was incompetent because "it was based upon the erroneous assumption that the Eminent Domain Code did not permit an accounting of the hotel's depressed revenue to inform the calculation of the after-taking value of condemnee's real property"; and (2) the verdict cannot be sustained solely on the theory that a decline in the oil and gas industry was responsible for the hotel's loss of income. The condemnee's testimony disputed that.

PennDOT argued that the condemnee's expert's opinion was not competent because it used depressed revenue to determine the after-taking fair market value, which the eminent domain code prohibited.

The court concluded that the testimony of PennDOT's expert was not competent, and, therefore, there was not support for the trial court's reason in affirming the jury verdict. The matter was remanded to the trial court for a new trial.

5th Circuit Court of Appeals Upholds Tax Court

***Nelson v Commr.*, 2021 U.S. App. LEXIS 32741 (Nov. 3, 2021)**

Facts. Mary Pat and James Nelson sought to plan their estate and formed a limited partnership, Longspar Partners Ltd., in 2008. Mary Pat and James named themselves general partners, with a 0.5% interest each. The limited partners were Mary Pat and trusts for their daughters. The majority of Longspar's assets were shares of stock in Warren Equipment Co., a holding company for several businesses. Mary Pat also contributed her limited partner interests to a trust where Mary Pat was the settlor, James the trustee, and their daughters the beneficiaries. The interests were transferred in two transactions, a gift and then a sale. The transfer agreement stated:

> [Mary Pat] desires to make a gift and to assign to [the trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 (the "Limited Partner Interest"), as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

The transfer agreement for the sale used largely the same language and was for a limited partnership interest having a fair market value of $20 million. The qualified appraiser rendered a report valuing a 1% interest at $341,000. "The Nelsons' attorney then used the fair market value as determined by the accountant to convert the dollar values in the transfer agreements to percentages of limited partner interests—6.14% for the gift and 58.65% for the sale." The IRS audited the Nelsons' gift tax returns and issued a deficiency notice of $611,208 for 2008 and $6,123,168 for 2009.

The Nelsons challenged in Tax Court, arguing that "they had sought to transfer specific dollar amounts through a formula clause and that the amount of interests transferred should be reallocated should the valuation change." The Tax Court found that a 1% value was worth $411,235 and that the language in the transfer documents was not a valid formula clause that could support reallocation of the interests. The Nelsons' appealed the court's finding that the transfers consisted of percentage interests, rather than fixed dollar amounts.

On appeal, the court stated "the Nelsons defined their transfer differently; they qualified it as the fair market value that was determined by the appraiser. Once the appraiser had determined the fair market value of a 1% limited partner interest in Longspar, and the stated dollar values were converted to percentages based on that appraisal, those percentages were locked, and remained so even after the valuation changed." The Nelsons' documents lacked specific language describing what should happen to any additional shares transferred if the valuation was sufficiently challenged.

The interpretation of the transfer documents was not changed by looking at any objective facts outside of the language of the documents. The appeals court determined that the documents were not ambiguous, and the Nelsons' interpretation was not reasonable as a matter of law. The Nelsons' interpretation would amount to changing and overriding the language in the transfer documents and Texas law did not allow for that. The subjective intent of the contracts considering the estate planning intent would not be allowed. "To support the Nelsons' reading, we would be required to disregard significant differences between these contracts and the transfer documents used in similar cases."

Hence, on appeal the Tax Court's denial of their petition for a redetermination of a deficiency of gift tax issued by the commissioner of Internal Revenue for the tax years 2008 and 2009 was affirmed.

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