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ES NPA Holding, LLC v. Commissioner
Tax Court finds arm's-length sale was best evidence of value

11th Circuit: Plaintiff entitled to damages for future lost profits

How financial experts can help in bankruptcy

Are PPP funds includable in business income for valuation purposes?

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ES NPA Holding, LLC v. Commissioner

Tax Court finds arm's-length sale was best evidence of value

A U.S. Tax Court case recently addressed the issue of whether a taxpayer received a *capital* interest or a *profits* interest in a partnership for services provided to the partnership. Capital interests are immediately taxable, while profits interests generally aren't taxable until distributions are received. In a nutshell, the characterization of the taxpayer's interest in this case depended on the partnership's fair market value.

Breaking down the transaction

The sole owner of several consumer loan businesses sold 70% of his interest in the businesses to outside investors for approximately $21 million. This equates to an implied value of roughly $30 million for 100% of all the businesses ($21 million divided by 70%).

This complex transaction involved several entities. Essentially, the businesses were held by a limited liability company (LLC) that was taxed as a partnership. After the sale closed, the investors held all the partnership's Class A units (with a capital account of approximately $21 million); the original owner held all the Class B units (with a capital account of approximately $9 million); and the taxpayer held all the Class C units (with a capital account of zero).

Determining the appropriate tax treatment

Under IRS guidance, a profits interest is considered speculative. Therefore, it's not immediately taxable if it's received "for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner." A capital interest, on the other hand, is immediately taxable.

A partnership interest is a *capital* interest if the holder would receive a share of the proceeds if the partnership's assets were sold at fair market value and distributed in a complete liquidation at the time the interest was received. If the holder wouldn't receive a share of the proceeds in such a hypothetical liquidation, then the interest is a *profits* interest.

In *ES NPA Holding*, the Tax Court found that the taxpayer met the underlying requirements for being classified as a tax-deferred profits interest. In so holding, the court rejected the IRS argument that these requirements weren't met because the taxpayer provided services to another entity involved in the transaction. It was undisputed, the court explained, that the services were performed "for the benefit of the future partnership."

The only question remaining was whether the taxpayer would receive a distribution upon a hypothetical liquidation of the partnership at the time

How creative deal structures can bridge the price gap

Valuation challenges often lead to a price gap between buyers, who fear overpaying, and sellers, who want to be sure they're fairly compensated. Fortunately, there are several creative deal structures that can help the parties bridge this gap. Common examples include:

Earnout provisions. These condition a portion of the purchase price on the achievement of certain performance benchmarks. If the business achieves its upside potential, the seller is compensated; if not, the buyer avoids overpaying.

Noncash consideration. Payment of all or part of the purchase price in the buyer's stock allows the seller to share in the business's upside potential.

Seller financing. This setup is usually cheaper for the buyer than stock consideration. Plus, the seller receives interest income and, if the sale is structured properly, favorable installment sale treatment for tax purposes.

These deal structures require careful planning and documentation. It's critical for the parties to review their options with their legal and financial advisors.

it received the Class C units. The LLC's operating agreement gave Class A and B unit holders a preferred return on their capital. In other words, the taxpayer's Class C units would receive a distribution only after the Class A and B unit holders' capital accounts were satisfied in full.

So, if the fair market value of the partnership — at the time of the hypothetical liquidation — exceeded the combined capital accounts of Class A and B unit holders, there would be money left over to provide a return to Class C unit holders, and the taxpayer would hold a *capital* interest that was immediately taxable. If the partnership's value was equal to (or below) the combined capital accounts of the Class A and B unit holders, the taxpayer would hold a tax-deferred *profits interest* in the partnership.

Valuing the partnership

The Tax Court agreed with the taxpayer that the best evidence of fair market value is "actual arm's-length sales occurring sufficiently close to the valuation date." In this case, the $21 million paid by the investors for their 70% interest provided the best estimate of value, and there was no evidence to suggest that the sale wasn't a bona fide, arm's-length transaction.

The court found the actual sales price more persuasive than a formal business valuation. However, the taxpayer's expert valued the partnership using the capitalization of earnings method. This valuation was comparable to the price obtained in the recent sale. The IRS expert valued the partnership at $52.5 million, but it appears that the expert erroneously assumed that the original owner sold a 40% interest, rather than a 70% interest.

Securing your position

Don't leave tax issues to chance. A partnership that wants to issue profits interests in exchange for services should carefully document the value of the partnership, as well as the arm's-length nature of any transactions involving partnership interests. Doing so will help ensure that the service provider achieves the desired tax treatment. ■

11th Circuit: Plaintiff entitled to damages for future lost profits

The U.S. Court of Appeals for the 11th Circuit in *WL Alliance, LLC v. Precision Testing Group, Inc.* upheld a jury award of $3.3 million, including $1.6 million in damages for lost *future* profits. The district court rejected the defendants' argument that lost future profits weren't recoverable because they were too speculative. The appellate court agreed, applying Florida state law.

Energetic dispute

The plaintiff (WL) partnered with the defendant (Precision) to provide specialized technicians to First Energy, an energy utility company. Under the arrangement, Precision formally contracted with First Energy while WL recruited the technicians and managed payroll. The partners agreed to split profits 50-50.

A disagreement arose about the amounts being remitted to WL, and the partnership was terminated. Precision's owner (another defendant in the case) terminated the contract between Precision and First Energy. Then he entered into a similar contract with First Energy using another entity he owned, effectively cutting WL out of the arrangement.

Once a plaintiff proves causation, it needs to provide only a "reasonable yardstick" to determine damages.

WL sued for wrongful disassociation from the partnership and breach of the partnership agreement and requested an equitable accounting. The defendants didn't counterclaim for a reciprocal accounting. At trial, the parties presented testimony on the value of the business and the prospect that the business with First Energy would continue for several more years.

The defendants made a pre-verdict motion for judgment as a matter of law. They argued that because the contract with First Energy was terminable at will, damages were too speculative, so there was insufficient evidence to support future damages. The district court denied this motion and the jury awarded WL $1.7 million in past damages and $1.6 million in *future* lost profits damages.

After the verdict, WL moved to moot its request for an equitable accounting, noting that it had discovered what it was owed through the discovery process. The defendants objected, arguing that an accounting was required under Florida law and moving to amend their answer to add a reciprocal accounting claim. The district court denied this motion, finding that Florida law didn't require an accounting and that the amendment wasn't timely. The defendants also renewed their motion for judgment as a matter of law, which the court also denied.

Appellate court decision

The 11th Circuit upheld the district court's denial of the defendants' motions. The court noted that judgment as a matter of law is warranted only when, "taking all evidence in favor of the non-movant, no reasonable jury could have reached a verdict for the non-movant." It also rejected the defendants' argument that there was insufficient evidence to support future damages. Although Florida law requires such damages to be proved with "reasonable certainty," the court explained that this standard applies to causation. Once a plaintiff proves that a defendant caused lost profits, it needs to provide only a "reasonable yardstick" to determine damages.

The appellate court found that the defendants' argument — that an at-will contract can't support future damages because it's not "an enforceable guarantee of future business" — overstates Florida law. It was sufficient that testimony from fact witnesses, including Precision's owner, showed that First Energy's need for technicians hadn't changed and wasn't likely to change in the future. The court explained that the jury could weigh this evidence and "rely on the 'common sense notion' that a sophisticated business would not radically change its business model suddenly and without cause."

Finally, the court rejected the defendants' argument that all damages were speculative without an equitable accounting. The defendants waived this argument by raising it for the first time in a post-verdict motion and, in any event, it was unsupported by Florida partnership law.

Looking to the future

A key takeaway from this federal appeals case is that damages that include future lost profits won't necessarily be deemed too speculative. If reasonably supported by sound reasoning, the evidence and applicable laws, courts can, indeed, look to the future. ■

How financial experts can help in bankruptcy

There's been a wave of business bankruptcies in 2023. The trend has been attributed, in large part, to rising borrowing costs, inflation and surging debt loads. Companies facing financial distress may find relief by assembling a team of experienced advisors to mitigate losses and, if possible, take corrective measures. This team should include professionals who understand financial, accounting, tax and business valuation matters.

Reorganization

Many businesses that experience financial distress are able to turn their situations around. The recovery process starts by identifying ways the company can regain control of its cash flows. Once a daily cash budget stops the immediate bleeding, a financial expert can help determine which form of bankruptcy is most appropriate — Chapter 7 (liquidation) or Chapter 11 (reorganization) — or whether the business can take steps to avoid bankruptcy altogether.

For example, a financial expert might develop projections for several reorganization options, including best-, probable- and worst-case scenarios. A Z-score formula may help assess a struggling company's

financial strength and estimate the risk and probability of whether the business will go bankrupt.

If a Chapter 11 filing is deemed appropriate, a financial expert can help "sell" a reorganization strategy, such as debt forgiveness and restructuring, to creditors. Many loans are overcollateralized because of the current conservative nature of banks. By appraising assets (including inventory, equipment and receivables), the expert can assist in renegotiating working capital covenants. As debt terms are eased, cash may be freed up for imminent needs.

Divestitures

Reorganization plans often call for companies to focus on core business operations and divest unprofitable segments. Alternatively, a distressed business might solicit an offer from a competitor or larger conglomerate to buy the company or its assets. Financial experts can help owners find potential acquirers and evaluate whether divestitures and offers to purchase assets or stock appear reasonable.

Reorganization plans often call for companies to focus on core business operations and divest unprofitable segments.

When minority shareholders or creditors contest a divestiture or sale, a financial expert can write a fairness opinion to help demonstrate that management exercised good judgment in analyzing the transaction. Fairness opinions are especially important when transactions involve related parties or if the CFO's compensation package includes a "golden parachute" clause.

Buyouts

Another unfortunate side effect of financial distress is shareholder disputes. When management squabbles impair daily operations and decision-making, owners may decide to split the assets — or one owner may choose to buy another's interest.

A valuation specialist can objectively estimate what the company and its underlying assets are worth. It also may be necessary to identify assets that aren't on the balance sheet, such as contingent liabilities, customer lists, brands and goodwill. In addition, the expert can explain the tax implications of buyout terms, such as installment sales and earnouts.

Liquidation

Unfortunately, some businesses aren't salvageable. When liquidation value exceeds going concern value, owners should consider filing for Chapter 7 bankruptcy protection.

A financial expert can facilitate the liquidation process as a court-appointed receiver and turnaround consultant. When serving this role, the expert would be charged with winding down operations and paying creditors in order of legal preference.

After the dust settles

In-house accounting personnel are often unfamiliar with how to account for changes following a reorganization, liquidation or buyout. A financial expert can help the new-and-improved business address its accounting and tax-reporting requirements going forward. ■

Are PPP funds includable in business income for valuation purposes?

If a business receives a Paycheck Protection Program (PPP) loan that's forgiven, should the proceeds be included in income for valuation purposes? A recent decision by the Supreme Court of Vermont addresses this question.

Background

The CARES Act was enacted in March 2020. It established the PPP to provide financial relief to businesses affected by the pandemic.

The program provided eligible businesses with loans guaranteed by the Small Business Administration to help cover certain operating costs. These loans were forgivable for businesses that maintained their payrolls at pre-pandemic levels and met certain other requirements.

Case in point

One of the issues in *Griggs v. Griggs* was the value of the husband's electrical contracting business — the largest asset in the marital estate. Both parties engaged valuation experts who valued the business using the capitalized earnings approach. The wife's expert valued the business at $719,000, while the husband's expert valued it at $580,000.

The most significant discrepancy between the two valuations was the appropriate treatment of PPP loan funds that the company had received. The husband's expert excluded them as a "one-time windfall." However, the expert recognized that "reasonable experts could differ" on whether to count PPP funds.

The wife's expert included around $87,000 in PPP funds in the business's income for 2020, stating that "valuation professionals tend to leave PPP income in because the intent of the PPP program was to replace lost income to encourage employers to keep employees on payroll." The trial court found that reasoning credible and adopted the higher value set forth by the wife's expert.

Upheld on appeal

The husband appealed, asserting that including PPP funds in income wasn't supported by the evidence and would make sense only if there was a loss of income for the year. The wife's expert countered that she included the funds based not on an overall loss of income, but because their purpose was to compensate for expenses incurred while the business was forced to shut down. The husband's expert eventually conceded that including PPP funds was a matter of professional judgment.

Vermont's Supreme Court ruled that the trial court didn't abuse its discretion by adopting the value set forth by the wife's expert, because it was "clearly supported by record evidence." As a result, the PPP funds were added to the company's income for valuation purposes.

A matter of dispute

As this case shows, the treatment of federal relief funds can be a matter of dispute. Contact a business valuation professional to determine what's right for your case. ■

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