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AN ANATOMY OF THE PROBLEMS IN A TAXABLE EXCHANGE ACQUISITION

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Fair Market Value in an arms-length transaction is defined as the price in terms of money which tangible property and intangible assets of an enterprise will bring if exposed in a normal market, allowing a reasonable time to find a purchaser who buys with knowledge of all the uses to which they may be adapted and for which they are capable of being used, with neither party being under compulsion to buy or sell.

Only rarely does the pure definition of Fair Market Value exist in an exchange of assets. Often one of the following conditions tilt a normal balance:

1. One party is under greater compulsion to act than the other;
2. The market is in an abnormal period compared to long-term market considerations;
3. Insufficient market exposure;
4. One or both parties are not fully informed.

The premium purchase is one result of the absence of pure Fair Market Value conditions. The allocation is then based upon a Fair Market Value less than the purchase price. This results in an upward allocation when all assets are valued. When they are not, intangibles by a gap approach are excessive to their proper weight to the whole, and valid depreciation deductions to the buyer are lost.

The bargain purchase is the other result of imbalanced Fair Market Value conditions. The allocation is then based upon a Fair Market Value more than the purchase price. Goodwill may still exist and its appraised level by an IRS engineer in the absence of

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PURCHASED GOODWILL IN AN INFLATIONARY RECESSION

Simultaneous recession and inflation are a deadly combination. The price/earning ratios of today are indications of high risks and often large corporations could be liquidated with their net tangible assets yielding more than the investing public's opinion of their total value. In such a dismal economic climate can one purchase goodwill with any substantial value?

Before discussing this subject it is important to understand what is meant by "Goodwill".

The definitions in Webster's Dictionary describe Goodwill as: "the custom of a trade or business; the favor or advantage in the way of custom that a business has acquired beyond the mere value of what it sells whether due to the personality of those conducting it, the nature of its location, its reputation for skill or promptitude, or any other circumstance incidental to the business and tending to make it permanent", and "the capitalized value of the excess of estimated future profits of a business over the rate of return on capital considered normal in the related industry".

Mr. Karl Ruhe, Chief of the Engineering Appraisal Branch of the Internal Revenue Service states a more succinct definition of Goodwill in an article he authored for The Journal of Accountancy in September, 1965: ". . . Goodwill can be summed up as the element or elements which provide an overall reasonable expectancy of economic preference in a competitive business enterprise". Although as Mr. Ruhe also says, ". . . mere earnings over and above a fair return on the tangible assets do not in themselves prove the existence of Goodwill, since they may be attributable to other factors", it is felt that the lack of earnings over and above a fair return on the tangible assets does usually disprove the existence of Goodwill.

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The usual procedure in any total valuation is to have already valued the tangible fixed assets and intangible assets which are separable from Goodwill. Their stability of value is somewhat different from Goodwill in that it is regulated by market demand opposed to excess earnings. The factors to be considered in converting excess earnings into Goodwill value are discussed in the following "Internal Revenue Service Valuation Guidelines".

The Internal Revenue Service in Revenue Ruling 68-609 offers specific guidelines for valuing Goodwill. This ruling is restated as follows:

"The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the currently outstanding portions of A.R.M. 34, C.B. 2, 31 (1920), A.R.M. 68, C.B. 3, 43 (1920), and O.D. 937, C.B. 4, 43 (1921).

"The question presented is whether the 'formula' approach, the capitalization of earnings in excess of a fair rate of return on net tangible assets, may be used to determine the Fair Market Value of the intangible assets of a business.

"The 'formula' approach may be stated as follows:

"A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say, 15 to 20 percent, is the value of the intangible assets of the business determined under the 'formula' approach.

"The percentage of return on the average annual value of the tangible assets used should be the percentage prevailing in the industry involved at the date of valuation, or (when the industry percentage is not available) a percentage of 8 to 10 percent may be used.

"The 8 percent rate of return and the 15 percent rate of capitalization are applied to tangibles and intangibles, respectively, of businesses with a small risk factor and stable and regular earnings; the 10 percent rate of return and 20 percent rate of capitalization are applied to businesses in which the hazards of business are relatively high.

"The above rates are used as examples and are not appropriate in all cases. In applying the 'formula' approach, the average earnings period and the capitalization rates are dependent upon the facts pertinent thereto in each case.

"The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. Further, only the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable, are used for determining earnings on the tangible assets. Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.

"The 'formula' approach should not be used if there is better evidence available from which the value of intangibles can be determined. If the assets of a going business are sold upon the basis of a rate of capitalization that can be substantiated as being realistic, though it is not within the range of figures indicated here as the ones ordinarily to be adopted, the same rate of capitalization should be used in determining the value of intangibles.

"Accordingly, the 'formula' approach may be used for determining the Fair Market Value of intangible assets of a business only if there is no better basis therefor available."

The important factors to be summarized from this ruling and our related comments are:

1. "Past earnings to which the formula is applied should fairly reflect the probable future earnings and more than one year (preferably five) should be used."
2. "The percentage of return on the average annual tangible net worth used should be the percentage prevailing in the industry at the date of valuation."
3. "The tangible assets entering into net worth, including accounts receivable in excess of accounts payable, are used for determining earnings on the tangible assets."

This statement requires consideration of not only the fixed assets, but the working capital. On any projected income approach, the additional working capital requirements must be considered.

4. An important factor not covered in this ruling is that excess or deficit earnings above or below those attributed to book values could be attributed to under-valued or over-valued tangible fixed assets or other intangible assets. Generally,

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PURCHASED GOODWILL IN AN INFLATIONARY RECESSION

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any valuation analysis due to inflation will reveal tangible fixed asset values more than their former book value. Separable intangible assets are seldom ever capitalized and thus are not reflected in book value.

The end answer is to inject appraised values in any residual income formula approach to avoid value accruing to Goodwill that is actually attributed to another asset.

AN ANATOMY OF THE PROBLEMS IN A TAXABLE EXCHANGE ACQUISITION

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an outside appraisal to test its validity and to find depreciable intangibles could reduce the depreciable base. It can also cause instant income to the buyer the first year from a decreased inventory value created via the downward allocation.

The two party agreement and unwritten disagreements in such transactions may be outlined as follows:

1. The buyer and seller reach an agreement as to a total lump sum price in a taxable exchange.
2. The divergent tax consequences of an allocation of the lump sum price places the parties in adversary positions.
3. Extending an agreement to include stipulated values for all of the parts can prove disastrous and either alter defined conditions for Fair Market Value or the transaction becomes scrubbed.
4. Assuming a taxable exchange is the only agreeable avenue to be followed, and to avoid controversy, each party will independently make their own allocation.

An allocation of a lump sum purchase price becomes necessary when it includes various classes of tangible property and intangible assets, along with current assets and assumed liabilities. The removal of cash and cash equivalent items provides the residual lump sum price subject to an allocation.

The tax regulations are clear on how the lump sum price subject to the allocation is to be allocated:

1. All of the assets exchanged are to be valued.
2. The Fair Market Value of all the assets are allocated or apportioned with equal weight to the

purchase price (excluding cash and cash equivalents).

The appraiser's role in the allocation may be summed up as follows:

1. Fair Market Value is estimated by appraisers but determined by the courts. The courts rely heavily on objective evidence presented by third party expert valuation witnesses and afford little if any credence to the obvious advocacy of interested parties.
2. An appraisal properly prepared and documented will by its own virtues provide the impetus for no contest and acceptance by the IRS, eliminating the costly hearings and court proceedings.

The parties in an acquisition have basic appraisal goal differentials. The buyer is interested in obtaining the maximum cash flow return via depreciation. The seller wants to avoid recapture of depreciation and have as much of his transaction taxed as capital gains opposed to ordinary income.

Despite the parties' divergent appraisal goals, the tangible fixed asset valuation techniques are the same for either the buyer's or the seller's appraiser. However, the intangible assets present two separate and distinct problems for the two appraisers.

The buyer's appraiser should make a most comprehensive analysis of all tangible assets acquired. Any intangibles that are separable from the mass intangibles, commonly referred to as goodwill, should be skillfully carved out. When the separated intangible assets have provable lives they are depreciable. Even when their lives are not provable and they are non-depreciable, should the separated asset be abandoned in the future it can be written off for tax purposes.

The seller's appraiser need not be concerned with separable intangibles (excepting patents) and his work load is lessened by treating all intangibles as a mass asset.

The described differentials in intangible asset valuation techniques can produce widely divergent conclusions and thus change an allocation even when all of the tangible asset Fair Market Values are the same.

The problem presented is not a breach of ethics between appraisers, but the scope of valuation limitations as required by the buyer and seller.

Legal and accounting advice is a necessity prior to entering into a sale or purchase of an enterprise. Appraisal advice after the fact to assist with an allocation of the purchase or sale price is helpful, but is a halfway measure. This advice requested prior to the transaction is of far greater value.

DOLLAR CONVERTER

The Dollar Converter is based on national averages for Replacement Cost New, and our interpretation of normal composite market indications. The Replacement Cost and the Market Value factors are multipliers to be applied to historical original cost. These factors should not be used in specific cases as many variables make up the averages indicated. Your mix of the variables may produce a very different answer.

Your dollar spent in earlier years is estimated at the following values today:

EXAMPLE APPLICATION OF THE DOLLAR CONVERTER

Our sample Enterprise completed their present plant in 1955 at costs of:

LAND	\$ 25,000
BUILDINGS	275,000
MACHY. & EQUIP.	<u>700,000</u>
	\$1,000,000

The Replacement Costs New of this original investment are:

LAND	\$ 75,000
BUILDINGS	764,500
MACHY. & EQUIP.	<u>1,638,000</u>
	\$2,477,500

The Resale or Used Market Values are respectively:

LAND	\$ 75,000
BUILDINGS	253,000
MACHY. & EQUIP.	<u>161,000</u>
	\$ 489,000

	INDUSTRIAL BUILDINGS		MACHINERY & EQUIPMENT	
	Repl. Cost New	Resale Value	Repl. Cost New	Used Market Value
10/75	1.00	—	1.00	—
1974	1.12	0.90	1.12	0.78
1973	1.22	0.94	1.30	0.82
1972	1.32	0.98	1.35	0.77
1971	1.44	1.02	1.39	0.71
1970	1.60	1.09	1.48	0.68
1969	1.70	1.11	1.57	0.64
1968	1.86	1.15	1.64	0.61
1967	1.97	1.16	1.70	0.56
1966	2.04	1.14	1.77	0.53
1965	2.13	1.13	1.82	0.49
1964	2.18	1.11	1.85	0.44
1963	2.24	1.10	1.87	0.41
1962	2.28	1.07	1.88	0.38
1961	2.33	1.05	1.88	0.34
1960	2.36	1.01	1.88	0.30
1959	2.39	0.98	1.90	0.27
1958	2.48	0.97	1.93	0.25
1957	2.54	0.94	1.98	0.24
1956	2.64	0.92	2.13	0.23
1955	2.78	0.92	2.34	0.23
1950	3.47	0.97	2.65	0.16
1945	5.42	1.25	4.33	0.13
1940	6.88	1.24	Generally Not	
1935	8.35	1.09	Applicable To	
1930	7.44	0.60	Normal Life Spans	

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