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VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC. 2013-1

Valuation of Government Contractor Companies

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As a business valuation expert, in recent years, I have encountered a number of situations in which closely held government contractor companies have had the need for a valuation of their business and the underlying stock in the business. First, I will identify those situations and, thereafter, I will outline the process of valuing government contractors and their underlying common stock.

- Contemplation of the sharing of stock ownership with employees through an ESOP (Employee Stock Ownership Plan) or an ISOP (Incentive Stock Option Plan).
- Evaluating an offer received to purchase the government contractor company.
- The gifting of a minority interest in the common stock of a government contractor company to members of the founder's family.
- The redemption of common stock from former employees of a government contractor company.
- To establish value for a buy-sell agreement between the government contractor company and certain members of the Company's management.
- For purposes of setting a price at which to sell off an unprofitable subsidiary.

Many of the above-noted transactions (i.e., ESOP, ISOP, gifting of stock) necessitate a detailed report on the value of the company in other cases (i.e., to evaluate an offer to buy the business) a summary report may suffice. Regardless of the manner in which the valuation is reported, there are generally accepted methods used to value the government contractor business and its underlying stock.

First, before the valuation is undertaken, there must be a clear understanding of: (1) the intended use of the valuation; (2) the ownership interest to be appraised; and (3) the applicable valuation date. The reasons why these factors must be delineated prior to undertaking the valuation is because they impact the result. For example, if the intended use of a valuation of company stock is for an ESOP, the opinion of value must be "fair market value," as opposed to other value measures (i.e., "fair value" or "investment value") and the unique aspects of the marketability of ESOP stock must be considered. The size of the ownership interest to be appraised (i.e., minority interest versus controlling interest in the company's common stock) and the features of the stock (i.e., voting privileges, dividends, etc.) are also important elements that impact the results of the valuation. These elements impact the methods used to perform the valuation (i.e., merger and acquisition method versus guideline company method) and the application of discounts or premiums. Since the marketplace for government contractors and other types of businesses is dynamic and changes over time, due to changes in the economy, government budgets, etc., business/stock valuations are prepared as of a specific date and are generally only relevant for a certain period of time (i.e., 90 days).

Normally, in an appraisal of a business and its underlying stock, value is determined by the selection and application of methodologies contained within three general approaches to value: market, income, and cost.

The first category, market, is a general way to determine a value indication of a company's common stock using one or more methods that compare the common stock in the company under appraisement to the stock of similar businesses that have been sold. Examples of the market

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SHOULD AN S-CORPORATION BE CONVERTED TO A C-CORPORATION FOR GIFT AND ESTATE PLANNING PURPOSES?

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One of the principal advantages of an S-Corporation is that it is treated for federal tax purposes as a pass through entity, passing most of its income and losses to the shareholders. Thus, at first glance, it appears to be desirable to maintain S-Corporation status thereby avoiding double taxation and providing an income stream to the shareholders. However, from a valuation standpoint, this may not be advantageous. Accordingly, the estate planner must carefully consider both valuation and income tax issues when determining whether it is in the best interest of the shareholders to convert an S-Corporation to a C-Corporation.

Valuation Issues: The reluctance by the IRS and the Courts[1] to permit the tax affecting of an S-Corporation's income results in a higher value of the shares of an S-Corporation for purposes of determining estate or gift tax values when compared to the value of a comparable C-Corporation because the net after tax earnings of the S-Corporation will be deemed to be greater than that of a comparable C-Corporation since the S-Corporations earnings will not be reduced by the shareholders personal income tax attributable to those earnings. This outcome results in a higher gift and estate tax burden for the S-Corporation shareholders.

Another critical factor in determining the advisability of converting an S-Corporation to a C-Corporation is the expectations of its shareholders. Oftentimes there is the assumption that an S-Corporation will distribute a greater portion of its income to its shareholders than a comparable C- Corporation. For example, assume a C-Corporation has $1 million of yearly income which is subject to a combined 40% federal and state income tax. The C-Corporation only has $600,000 which it can distribute to its shareholders and that distribution will be taxed to the shareholders at the then dividend tax rate. In these circumstances, assuming a combined federal and state dividend rate of 20%, the shareholders of the C-Corporation will net $480,000 (80% of $600,000). The S-Corporation with $1million of yearly income can distribute $1million to its shareholders. Assuming the S-Corporation shareholders marginal tax rate is 40%, the S-Corporation shareholder will net $600,000 rather than $480,000. In circumstances where the S-Corporation, in the aforementioned example, does not distribute any of its income to its shareholders an argument could be made that the value of a shareholders S-Corporation stock should be less than the value of comparable C-Corporation stock, since the S-Corporation shareholder has a $400,000 tax liability (40% of $1 million), but no cash to pay the tax. However, most S-Corporation agreements require the S-Corporation to distribute sufficient cash to permit a shareholder to pay the income tax on the income attributable to the shareholder.

Income Issues: An S-Corporation has more favorable income tax results when compared to a C-Corporation since the combined current corporate tax and dividend tax is greater than an individual's marginal income tax rate. So today, when we ask the question should an S-Corporation be converted to a C-Corporation for gift and estate planning purposes, the answer is most likely no as a result of the more favorable income tax benefits inuring to an S-Corporation's shareholders.

However, this may not be the case in the future if Congress modifies the Internal Revenue Code by substantially reducing the corporate tax rate. Thus, if the corporate rate is substantially reduced and the dividend rate remained the same, and the marginal income tax rate is increased on income in excess of $200,000, then it may be advisable to convert an S-Corporation to a C-Corporation for gift and estate planning purposes.

Assume the corporate tax rate is reduced to 20%, the dividend rate remained the same (15%), and the marginal income tax rate for income in excess of $200,000 is increased to 40%. Giving effect to federal taxes, the S-Corporation shareholder would be subject to a marginal 40% income tax rate, whereas a C-Corporation shareholder's income would only be subject to a combined 35% rate, 20% at the corporate level and 15% on the personal return. If a corporation generates $1million in income and is subject to a 20% income tax it can distribute $800,000 (80% of $1 million) to its shareholders who would pay a tax of $120,000 (15% of $800,000) netting the C-Corporation shareholder $680,000, compared to the $600,000 (60% of the $1 million) which the S-Corporation shareholder would receive. ❒

[1]Gross v. Commissioner, T.C. Memo. 1999-254, Wall v. Commissioner, T.C. Memo. 2001-75, Estate of Gallagher v. Commissioner, T.C. Memo 2001-148.

approach include the Guideline Company method and the analysis of prices paid for similar companies in the merger and acquisition marketplace.

The Guideline Company method requires an investigation and analysis of publicly traded companies similar to the company under appraisement, with regard to type of products/services provided, financial performance, etc. Examples of publicly traded government contracting companies investigated for use as guideline companies in the valuation of private government contracting companies include the following: Advanced Communication Systems, Inc.; BTG, Inc.; CACI International, Inc.; Comarco, Inc.; GRC International, Inc.; GTS Duratek, Inc.; Government Technology Services, Inc.; Maximus, Inc., and OAO Technology Solutions, Inc., among others. Market multiples for the publicly traded guideline companies are determined based on the ratio of the price of their stock to various parameters, such as earnings, cash flow, or revenues. In selecting market multiples for the company under appraisement, the appraiser considers the relative financial condition and operating performance of the company in comparison to the publicly traded guideline companies. Adjustments to these market multiples are considered to reflect the differences between the company under many times larger, publicly traded companies. Premiums or discounts are applied to the values derived by application of the market multiples to reflect the differences in level of ownership (minority versus majority) and marketability.

The merger and acquisition method, meanwhile, involves deriving indications of value for the company under appraisement from prices at which entire companies in similar lines of business have been sold or the prices at which significant interests in similar companies changed hands. The general notion of the merger and acquisition analysis is the same as the guideline public company analysis, i.e., the price at which the transaction took place is related to fundamental variables that affect the value. There are various sources from which this information, if available, is obtained, including business brokers, public filings, merger and acquisition databases, etc.

The second general category of value determination, income, requires that the earnings capacity of the company under appraisement be investigated and the resultant indicator of expected earning capacity, whether it is derived from past, current, or projected earnings, be capitalized at a rate sufficient to satisfy the investment and business risk requirements of ownership. The application of this approach usually requires a sufficient earnings history to help give a clear indication of expected future performance. The income approach considers the company's future revenues and its earning potential, along with its estimated capital requirements. The income approach is typically applied in the form of a discounted cash flow analysis. Application of the discounted cash flow analysis, normally entails the projection of revenues, expenses, earnings and cash flows, for five years following the valuation date, which are then discounted to their present value.

Application of the income approach to the valuation of the common stock of a government contractor, through the discounted cash flow analysis, begins with the projection of revenues for the company for five or ten years into the future. The projection of future revenues should consider the company's historical revenue levels, its backlog of contracts as of the valuation date, the overall economy, and government budgets, as well as other relevant factors. The discounted cash flow analysis also entails the forecasting of the company's future expense levels, as well as its capital requirements for fixed assets and working capital. These forecasts are generally developed based upon an analysis of the company's history and those of other similar companies, such as the publicly traded government contractors noted above. The estimated future cash flows of the government contractor company are then discounted to present value through utilization of a discount rate (interest rate) that reflects the perceived risk of achieving those projections. For example, if the projections for the government contractor company under appraisement were principally based on existing government contracts and the contract backlog in place as of the valuation date, the risk would be lower, and that factor would be reflected in a lower discount rate.

The third category of value determination, cost, involves a consideration of the net book value, adjusted book value, or estimated liquidation value of the company under appraisement. Usually, the most recent balance sheet statement at or close to the appraisal date is utilized. Net book value considers only historical costs and, as a result, is not considered a reliable indicator of the fair market value of the common stock of a government contractor, the value of which is principally impacted by current and future revenues and earnings. As such, the cost approach to valuation is rarely if ever used to value the common stock of a government contractor.

A final value conclusion for the government contractor company and its underlying common stock is estimated by comparing the value indications developed through application of the market approach and the income approach. Based on the judgement of the business valuation expert, a final value is developed. The purpose of the valuation generally has an impact on the final value conclusion. For example, if the purpose of the valuation is to negotiate the sale of the company, the future outlook for the company is a principal determinant of the value and as a result, the value developed by the income approach would most likely be given greater consideration. Alternatively, if the purpose of the valuation was for gifting or litigation, historical and market data is generally deemed more credible than forecasts and as a result, the value developed by the market approach would most likely be given greater consideration. ❒

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– Dale Carnegie

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