KTS, INC.

VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC. 2012-2

# RAY J. KLARIS, PRESIDENT - RETIRES

Klaris, Thomson & Schroeder, Inc., President, Ray J. Klaris with over 50 years in the appraisal profession will officially retire at the end of December 2012. Mr. Klaris began his career back in the early 60's as an Appraiser and Appraisal Services Director in charge of real estate and Institutional appraisals with Marshall and Stevens Incorporated. From 1966 to 1968 Mr. Klaris served as Senior Appraiser with Tait Appraisal in Los Angeles and San Francisco. In 1968, Ray became VP and Regional Manager of Tait in San Francisco and in 1970 he served as VP of Tait-Los Angeles. Mr. Klaris rejoined Marshall and Stevens in 1973 and became Area Appraisal Manager of the Western Area in 1974. In 1977, Mr. Klaris became Vice President/Consulting and in 1983 he was a Senior Valuation Consultant. In 1993, Ray Klaris, Co-Founder, became President and Senior Valuation Consultant for Klaris, Thomson & Schroeder, Inc.

He received his B.S. Degree with a major in Agriculture Economics from the University of California, Davis in 1955, and in 1961 he received his M.B.A. Degree at the Graduate School of Business, University of California at Los Angeles. Mr. Klaris was a Senior Accredited Member of the American Society of Appraisers with a specialty in business valuations. He also completed Real Estate courses for the American Institute of Real Estate Appraisers. Mr. Klaris is a past Senior Residential Member of the Society of Real Estate Appraisers. He has qualified as a Class IV Appraiser by the Commissioner of Savings and Loan, State of California, in 1964; and approved as a qualified appraiser for the California State Division of Corporations in 1967. He is a member of Beta Gamma Sigma, a National Business Administration Honorary Scholastic Society. Mr. Klaris is a past President of the Los Angeles Chapter of the Society of Real Estate Appraisers (currently the Appraisal Institute).

Over the years Ray did a fair amount of valuation work for the Internal Revenue Service including the valuation of the Molokai Ranch Company in Hawaii, and the Estate of Howard Hughes. Mr. Klaris has testified as an expert witness before the Superior Court, Contra Costa County, California; Commissioners appointed by the Superior Court, County of Los Angeles; Superior Court, County of Orange; U.S. District Court, Los Angeles; and before the Tax Appeals Board, City and County of San Francisco and County of Los Angeles, California.

Mr. Klaris has been a mentor, friend and inspiration to many colleagues. His contributions, work ethics and professionalism has been a model and a tribute to the appraisal industry. We sincerely appreciate all his countless gifts of time and talent through the years and wish him much happiness and continued success in his retirement with his lovely wife Barbara. Ray, we've enjoyed the pleasure of your company; thanks for everything—you will be missed, but not forgotten! ❐

## IN THIS ISSUE

# United States Tax Court Case Summary
# T.C. Memo 2011-148
# Estate of Louise Paxton Gallagher, Petitioner versus Commissioner of Internal Revenue Service, Respondent
# Judge Halpern

*By: Mr. John A. Thomson, ASA, MAI*
*Managing Director/VP*

The primary issue in the case was the valuation of 3,970 membership units (a 15% interest) in the business enterprise known as Paxton Media Group LLC and subsidiaries ("PMG") as of July 5, 2004.

**Background**

On September 30, 2005, the estate filed a form 706 on behalf of the decedent's estate. The return claimed a fair market value of $34,936,000 or $8,800 per unit, as of July 5, 2004, based upon an appraisal of the Company's units by David Michael Paxton (PMG's President and Chief Executive Officer). The respondent, upon examination, determined the value to be $49,500,000 on June 13, 2007 based on Leslie Avener, ASA (an IRS appraiser).

After unsuccessful settlement negotiations with the respondent and an appeal request to the respondent's appeals office, the petitioner then obtained an independent appraisal from Sheldrick, McGehee & Kohler ("SMK") appraising the units at $26,606,940 or $6,702 per unit as of the valuation date. On July 8, 2008,the petitioner filed a petition with the Tax Court for redetermination of the deficiency based on the SMK appraisal. However, before the start of trial, the petitioner hired another appraiser, Richard C. May, who valued decedent's units at $28,200,000 or $7,100 per units. The respondent hired Klaris, Thomson & Schroeder, Inc. ("KTS") to value decedent's units as of the valuation date; KTS determined a fair market value of $40,863,000 or $10,293 per unit At trial, the petitioner claimed $28,200,000 or $7,100 per unit, based on Mr. May's appraisal[1] and the respondent claimed $40,863,000 or $10,293 per unit, based on the appraisal by KTS.

**The Company**

The Company publishes twenty-seven daily newspapers and more than thirty related weekly newspapers. The Company also owns and operates an NBC affiliated television station and radio station in Kentucky. PMG traces its roots to 1896 when it launched its first newspaper. The Company has 2,000 employees and 61 shareholders. The largest single shareholder at 15.0% was the decedent. The president and CEO of the Company, David Paxton, had been valuing the Company annually for the last several years for purposes of buying back shares. He primarily used the guideline company approach, supported by an income approach.

**Valuation Issues**

*Guideline Approach*

The first issue was what approaches were used and the Court's critique of each approach. Both the petitioner's expert and the respondent's expert utilized the guideline company approach and the income approach (discount cash flow). The petitioner's expert used the guideline approach to support his income approach but gave it no weight, so the court did not comment on the petitioner's guideline approach. KTS, the respondent's expert, also utilized the guideline approach and did give 50% weight to the approach. The Court commented as follows on the respondent's (KTS) guideline approach:

> "We find that Mr. Thomson improperly relied on the guideline company method because the four guideline companies alone were not similar enough to PMG to warrant its application."

It is interesting to point out that the four (4) guideline companies used by KTS were 4 of the 5 used by Mr. Paxton in his annual valuations of the Company and 4 of the 7 used by the petitioner's expert. KTS had started with 13 and selected the best 4. One of the companies used by Mr. Paxton and 3 by the petitioner's expert were eliminated based on significant size differences. We (KTS) believed this is the cleanest approach as it did not revolve around tax affecting or not tax affecting as does the discount cash flow approach. KTS' guideline approach conclusion was 11% higher than its income approach conclusion, so this was a benefit to the taxpayer.

The remaining issue involved which financial data to use and certain adjustments to the financial data and application of the discount cash flow approach.

*Financial Data*

The date of value was July 5, 2004. The court stated that Mr. Thomson based his valuation analysis on data gathered from PMG's internally prepared financial statements ending June 27, 2004 and financial information for comparable public companies as of the quarter ending June 30, 2004. He considered that information to be more accurate than earlier data, despite the quarterly report's publication 1 or 2 months after the valuation date. In contrast, Mr. May's report relies upon financial information for comparable public companies ending March 28, 2004, the latest quarterly data available before the valuation date, and PMG's internally prepared financial statement ending May 30, 2004, the latest statements published before the valuation date. Mr. May declined to use the June 2004 financial statements, stating, that a willing buyer and willing seller would be unaware of the information as of the valuation date since the statements likely would not have been closed and published by such date. The Court went on to say, we agree with Mr. Thomson that the June 2004 financial information should be used in valuing decedent's units.

*Adjustments to Financial Data (Historical)*

Both Mr. Thomson and Mr. May adjusted for a gain on divested newspapers in the year 2000. However, Mr. May attempted to adjust earnings for certain life insurance and favorable health care claims experienced from PMG's self-insured health insurance. The Court stated, we disagree with Mr. May's self insured health insurance and life insurance policy adjustments because he provided no explanation as to why the gains were non recurring.

**Discount Cash Flow Method ("DCF")**

The court starts out by stating the following:

"Given the lack of public companies to PMG, we agree that the DCF is the most

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***United States Tax Court Case Summary, T.C. Memo 2011-148, Estate of Louise Paxton Gallagher, Petitioner versus, Commissioner of Internal Revenue Service, Respondent*** *(cont. from page 2)*

appropriate method under which to value the units."

The Court basically accepted Mr. Thomson's discounted net operating margin (net EBITDA) approach with one exception[2]. The Court added back depreciation (3.1% of revenue) to Thomson's operating margin. The Court stated "because we are discounting PMG's cash flow, we modified Mr. Thomson's forecasted operating margin to include Mr. May's projected depreciation deduction of 3.1% of revenue, which we find to be a reasonable projection."

Some of the Court's comments on why they did not accept Mr. May's cash flow inputs are interesting and educational and we comment on them in the following paragraphs.

1. We do not have confidence in Mr. May's projection as it is based on improper earnings and newsprint cost adjustments. We determine Mr. Thomson's analysis to be reasonable.

2. Both Mr. Thomson's and Mr. May's adjusted PMG's operating income to reflect other income (expense) from affiliate company management fees and equity in net income of affiliate company. However, the Court disagreed over whether to also add other net income and net pension income (expense). As stated earlier, we diregarded Mr. May's exclusion of these items from PMG's historical financial statements. We adopt Mr. Thomson's projection of other income which we consider reasonable.

3. Mr. May failed to explain his reason for tax affecting PMG's earnings and discount rate and for employing two different tax rates (39% and 40%). Absent an argument for tax affecting PMG's projected earnings and discount rate, we decline to do so. As we stated in Gross versus Commission, T.C. Memo 1999-254, the principal benefit enjoyed by "S" Corporation shareholders is the reduction in their total tax burden, a benefit that should be considered when valuing an "S" Corporation. Mr. May has advanced no reason for ignoring such a benefit, and we will not impose an unjustified fictitious corporate tax rate burden on PMG's future earnings.

4. Mr. May did not justify his projection of capital expenditures. We consider Mr. Thomson's projection of 2.77% of revenue to be reasonable. Conversely, not only does Mr. May fail to support his projection but PMG's financial statements do not justify his estimated increase in capital expenditures.

5. Although not convinced by either expert on their conclusion of the discount rate, the Court accepted Mr. Thomson's build-up method and his discount rate. An important component of the discount rate (in this case the weighted average cost of capital WACC) was the debt to equity ratio used. The Court's thoughts on this area opined by the two experts follows:

> "Petitioner argues that Mr. Thomson erroneously used book, rather than market values in determining the equity and debt ratios. We agree that market values of a company's debt and equity are to be used in estimating its weighted average cost of capital. However, because both experts rely on the WACC formula and PMG's own market values are unknown because of its closely held company status, we must determine the appropriate debt and equity ratios on the basis of the persuasiveness of the expert's analysis. Mr. Thomson testified that he used the Company's own capital structure because the decedent could not affect PMG's capital structure as a minority interest unit holder. In contrast, despite Mr. May's conclusion that the guideline companies were not comparable under the guideline company method, he declared that the same companies were sufficiently comparable under the DCF method to justify using their capital structures to calculate PMG's WACC. We lend no weight to Mr. May's wavering stance and therefore use PMG's own capital structure at book value for purposes of this case. We agree with Mr. Thomson that the weighted average cost of capital for PMG is 10% (rounded), as our modification to Mr. Thomson's cost of equity capital determination does not materially alter this result."

6. <u>On Long Term-Debt</u>

We shall adopt Mr. Thomson's long-term debt conclusion of $243,602,413. Moreover, Mr. May identified differing debt amounts throughout his report, we will not rely on a consistently changing number, especially one that Mr. May fails to justify.

7. <u>On Working Capital</u>

We do not find Mr. May's analysis to be persuasive. Mr. May once again failed to explain why the public companies that he deemed to be not comparable to PMG under the guideline company method provide a sufficient comparison upon which to base a working capital adjustment. We lend little weight to his seemingly contradictory position.

We shall ignore Mr. May's working capital projections because of their complete lack of support. After analyzing the record, we are persuaded that PMG's historical performance justifies Mr. Thomson's projection of working capital levels and we find in accordance.

Lastly, the Court accepted Mr. Thomson's marketability discount of 31% (Mr. May's was 30%) but adjusted Mr. Thomson's lack of control discount from 17% to 23%. The Court's conclusion along with the expert's conclusions pre-trial and trial follows:

**SUMMARY OF VALUATION CONCLUSION PRE-TRIAL, TRIAL COURT AND AMENDED COURT**

| SOURCE | VALUE | VALUE/UNIT |
|---|---|---|
| 1. Taxpayer based on Company's CEO (filed on 706 by estate) | $34,936,000 | $ 8,800 |
| 2. Sheldrick, McGeehee & Kohler for the taxpayer | $26,606,940 | $ 6,702 |
| 3. IRS appraisal by Leslie Avener | $49,500,000 | $12,468 |
| 4. Taxpayer's report for trial Mr. May | $28,200,000 | $ 7,100 |
| 5. IRS report for trial Mr. Thomson | $40,863,000 | $10,293 |
| 6. Court's Opinion | $32,601,640 | $8,212 |
| 7. Courts Opinion Revised[3] | $35,761,760 | $ 9,008 |

[1]SMK did not testify at trial.

[2] The Court also adjusted the enterprise conclusion based on the discount cash flow by what they refer to as the diluted impact of certain outstanding options.

[3]Judge Halpern issued a supplemental opinion recognizing he made an error in his calculation in his first opinion. No one is perfect.

# KTS CALENDAR

**Recent seminars and speaking engagements:**

| | |
|---|---|
| 08/30/12 | St. Louis University - School of Orthodontics, *"Three Approaches to Valuing Closely Held Practices: Asset, Income, and Market"* |
| 09/07/12 | KTS Booth - Missouri Bar Annual Estate & Trust Institute - Springfield, Missouri |
| 09/14/12 | KTS Booth - Missouri Bar Annual Estate & Trust Institute - Jefferson City, Missouri |
| 09/21/12 | KTS Booth - Missouri Bar Annual Estate & Trust Institute - Kansas City, Missouri |
| 09/28/12 | KTS Booth - Missouri Bar Annual Estate & Trust Institute - St. Louis, Missouri |

# ANNOUNCEMENTS

KLARIS, THOMSON & SCHROEDER, INC. WOULD LIKE TO EXPRESS OUR SINCERE CONDOLENCES FOR A WONDERFUL LADY, MARY KAY THOMSON. 10.16.12 REST IN PEACE MARY KAY.

FROM ALL OF US AT KLARIS, THOMSON & SCHROEDER, INC. HAPPY AND SAFE HOLIDAYS!

**KLARIS, THOMSON & SCHROEDER, INC.** is a full service valuation and consulting company specializing in business valuations, intangible asset valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

*For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to ktsinc@verizon.net.*

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*"Don't limit yourself. Many people limit themselves to what they think they can do. You can go as far as your mind lets you. What you believe, remember, you can achieve."*
– Mary Kay Ash