Barber Analytics

Valuation Issues in Gift and Estate Tax- September 2014

Barber Analytics, LLC, 1 Sansome Street, Suite 3500, San Francisco, CA 94104 415-946-8914

Estate of Adell – The Tax Court Wades into Murky Waters

The Tax Court released its opinion in the *Estate of Adell* in August. The case makes for some very interesting reading as Judge Paris explores the inner workings of a religious broadcasting channel called *The Word*. Even more interesting from a valuation perspective, is the organization of the related entities that provide support to *The Word*, where the cash flows before and after the death of Mr. Adell, and where the real power lies to control those cash flows. Judge Paris reaches a reasonable value conclusion given the wide gap between the IRS and the estate, although as usual, I would have reached a slightly different conclusion.

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The Pertinent Facts

Franklin Z. Adell passed away on August 13, 2006 (also the valuation date) while the owner of a 100% interest in STN.Com (STN), a C-corporation. STN's sole businesses activity was providing broadcasting services to *The Word Network* (*The Word*). Kevin Adell, Mr. Adell's son, was the President of STN. Kevin, as a trusted family member, did not have an employment or non-compete agreement with STN. STN had about 30-35 employees and several million dollars of broadcasting equipment on the valuation date.

The Word was a tax exempt 501(c) (3) organization that produced an urban religious programming channel. Although the President of *The Word* was Mr. Adell, Kevin actually cultivated the relationships with the churches and ministers that made up the content of the channel. Through relationships with religious leaders, which included Bishop Charles Haywood Ellis and Reverend Jesse Jackson, and DirecTV, *The Word* was created and broadcast throughout the US. *The Word's* primary source of revenue was from broadcasting contracts with the ministers and their religious affiliates.

The financial relationship between *The Word* and STN was theoretically governed by a Services and Facilities Agreement (the Agreement) which required *The Word* to pay to STN the lessor of i) actual costs incurred in providing the broadcast services and ii) 95% of *The Word's* programming revenue. *The Word* in its application for tax exempt status agreed that any transactions between itself and STN would be at arm's length and below cost to prevent any private inurement or benefit.

In the five years before the 2006 valuation date, *The Word* paid out substantially all its revenue ($7.6 - $16.8 million annually) to STN. STN, in turn, paid its expenses that included salaries to Mr. Adell and Kevin which totaled about $3.2 to $8.6 million annually. In addition, STN paid personal expenses for Mr. Adell and his son which included lease payments on leased luxury cars, including Bentleys and Rolls-Royces.

Valuation Reports

The first valuation report filed by the estate was dated June 15, 2007. It valued STN at $9.3 million using the discounted cash flow method (DCFM). In the forecast of operations the valuation analyst adjusted officer's salaries to market levels, but added an economic charge for Kevin's goodwill, which increased expenses by approximately $8 to $11 million per year. The estate's appraiser did not adjust the level of income from *The Word* for the reduction in costs (salaries) which would be required under the Agreement. In addition, STN's net asset value was considered, but dismissed, as the going-concern value (DCFM) was greater.

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The estate filed an amended Form 706 on August 10, 2010, almost four years after Mr. Adell died, changing its original position, and stating that STN had no value at all. It doesn't appear the estate had a valuation report to support this position. What appears to have motivated the estate to file a new Form 706 was a family disagreement which ultimately led to the effective dissolution of STN. Kevin's sisters filed suit against him as trustee for his father's trust. Kevin then effectively shut down STN and transferred its workforce, assets and the Agreement to a new entity under his sole control.

The IRS issued a notice of deficiency dated November 10, 2010 stating the value of STN was $92.2 million. The estate later filed two more valuation reports both valuing STN at $4.3 million using the net asset value method (NAVM). The estate filed these two new reports to correct the mistake of not adjusting revenues when the appraiser adjusted costs, as the Agreement would have them do.

Before trial the IRS submitted their expert report valuing STN at $26.3 million. The IRS expert used the DCFM and adjusted officer salaries, as the estate did in its initial report. However, making the same error as the estate, the IRS expert did not consider how adjusting officer salaries would impact the fees payable to STN by *The Word*. The IRS expert did not take an economic charge for Kevin's personal goodwill, but tried to recognize his value through a salary adjustment.

That Kevin ultimately held all the power to control the cash flow of STN and* The Word *was very apparent when he closed STN and opened a new company to provide the same services.

The Court's Opinion

The Tax Court ultimately concluded that the most reasonable conclusion was the initial opinion filed by the estate - $9.3 million. The Court stated that STN was profitable before Mr. Adell's death and that "it was reasonable to conclude that it would continue to be profitable after." In fact, the Court cited post-valuation-date financial information to substantiate its conclusion that STN would continue to be profitable while *The Word* did not enforce the language in the Agreement. In the event *The Word* did enforce the terms of the Agreement, the Court believed it was reasonable to conclude STN would expand its business to provide similar services to other clients. Finally, the Court speculated that if a buyer that wanted to participate in management was found, the salary of the buyer could remain high, reaping the same benefits as Kevin and his father had prior to Mr. Adell's death.

Having concluded a going-concern approach was best, the Court ultimately decided the estate's application of the personal goodwill charge to income was more accurate. Judge Paris points out that Kevin had abundant personal goodwill that had not been assigned to STN through contract. That Kevin ultimately held all the power to control the cash flow of STN and *The*

"My family wants a genuine back-to-nature camping experience, but with Wi-Fi, air conditioning, and satellite TV."

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BA Perspective

The Tax Court did a reasonably good job of getting to the heart of the issue: Most of STN's cash flow was a result of Kevin's personal goodwill. Judge Paris however, should have focused his analysis more closely on a sale to a hypothetical buyer and its likely terms, as fair market value requires. The appraisers didn't appear to do a good job of exploring sale options either. The Court seemed to view the 100% interest in STN in part like a minority interest (with current ownership and management in place after the sale) rather than the control interest it was. Judge Paris spent a good deal of space in his opinion discussing historical and post-valuation date results. The reality is a hypothetical buyer of STN would likely be forecasting very different financial results than those that occurred in the past, or after the valuation date.

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The central issue in this case is what would happen to the Agreement between STN and *The Word* in a sale. My sense is a buyer of STN would not want to take on the Agreement for a few reasons. First, if enforced, the Agreement doesn't provide for adequate returns. Second, no buyer would want to expose themselves to the risk that the historical cash flows would stop if the Agreement was accepted as is, and then later was enforced. Third, and probably most importantly, the relationship between *The Word* and STN seems to be at odds with the prohibition of private inurement. Very few buyers would want any connection to the potential liabilities associated with *The Word*-STN relationship.

Admittedly, there is plenty of room for judgment in this case, and different sale scenarios could lead to different value conclusions. A scenario worth considering though would be a sale to another broadcasting company looking for capacity and expertise (i.e., the workforce), excluding the Agreement. Kevin would take the Agreement (and potential liabilities) to another entity controlled by him to continue enjoying the benefit of the value he created. In this circumstance my sense is the value of STN would be less than the $9.3 million the Tax Court concluded, but higher than the $4.3 million liquidation value.

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Barber Analytics, LLC
1 Sansome Street, Suite 3500
San Francisco, CA 94104

Phone: 415.946.8914

Website: www.barberanalytics.com