THE FINANCIAL VALUATION GROUP

When Results Count

Consulting • Valuations • Expert Testimony

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Tax Valuation E-Flash

Caracci v. Commissioner, 118 T.C. No 25, May 22, 2002

In a reviewed opinion written by Judge Laro, the Tax Court determined that three 501(c)(3) home health care organizations had a higher fair market value than the value determined by the taxpayers when the organizations were converted to S corporations.

The Sta-Home entities consisted of three 501(c)(3) home health care providers located in Mississippi. Members of the Caracci family were the owners, officers, and directors. In 1995, Sta-Home (which shall refer to all entities hereafter) was converted to an S corporation. Sta-Home had a history of operating losses and the book value of assets was less than liabilities. Reasons that Sta-Home wished to convert to a profit corporation included: the need to raise capital and/or enter into profit- making ventures, in view of the past losses and accumulated deficit; the ability to participate in major changes taking place in the health care industry,

> A hypothetical buyer may be one of a class of buyers who is positioned to use the purchased assets more profitably than other entities.

including mergers and acquisitions; the provision of ownership interests for succession plans to keep key management in place; and the ability to deal with changes in the reimbursement system within the near future.

One of the key valuation issues was whether any value should be given to the Sta-Home tax-exempt entities' cost-shifting attribute. Cost-shifting could attract prospective purchasers, such as hospitals, that desired to acquire a home health care agency and use its cost-shifting capacity. The Tax Court concluded that attributing value to this mechanism was consistent with the requirement that fair market value be determined using a hypothetical buyer. The Court said, "A hypothetical buyer may be one of a class of buyers who is positioned to use the purchased assets more profitably than other entities. Accordingly, we have held that fair market value takes into account special uses that are realistically available because of a property's adaptability to a particular business. Acknowledging the existence of such businesses in the universe of hypothetical buyers also is consistent with the standard that assets are

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not valued in a vacuum but, instead, are valued at their highest and best use." [Citation omitted]

Prior to the S corporation conversion, Sta-Home's accounting firm performed an appraisal and determined that the fair market value of the net assets was negative. Counsel for Sta-Home did not believe this appraisal complied with Revenue Ruling 59-60 or properly considered intangible assets. Sta-Home obtained a second appraisal and this appraisal also showed that fair market value was negative. The second appraiser relied primarily on the asset approach, which included a $2,100,000 intangible asset for "Workforce-in-place". The appraiser corroborated his findings using market transactions. These transactions were only used as corroborating indicators of fair market value since the comparable sales were too "idiosyncratic" to be reliable. He determined that there were no comparable guideline public companies from which valuation multiples could be derived

The IRS appraiser was challenged by the taxpayer under Daubert v. Merrill Dow Pharm., Inc. The Tax Court denied the challenge, saying the contentions were, "nonsensical and border on the frivolous." This appraiser relied on the income and market approaches in determining fair market value. Under the market approach, the appraiser used a multiple of revenue to the market value of invested capital (MVIC), which includes both interest bearing debt and equity. Under the income approach, he used a 12.8% capitalization rate applied to a benefit stream that

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took into account the potential for cost shifting. He concluded that the fair market value of the net assets was approximately $7,000,000.

The Tax Court was "unimpressed and unpersuaded" by the taxpayer expert's report. The Court said, "His reasoning that the Sta-Home tax-exempt entities had a fair market value of less than zero is unconvincing, and, in fact, appears to be more an advocacy of petitioner's litigating position than a candid fair market value appraisal. We think a willing buyer would be puzzled and confused by his conclusions." The Court was also critical that the valuation conclusions did not seem to comport with several articles written by this expert.

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The Tax Court also disagreed with portions of the IRS expert's appraisal. The Court believed this expert did not sufficiently consider Sta-Homes lack of some of the more sophisticated and remunerative home health care techniques, such as infusion and respiratory therapies, in developing his price to revenue multiple. For the benefit stream in the capitalization method, the Court said the appraiser included "too many imponderables."

The Tax Court concluded that the fair market value of the net assets was $5,164,000.

The case includes substantial discussion of the "intermediate sanctions" applied to the transaction, but this is outside of the scope of this newsletter and readers should read the full text of the case, available on our website.

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