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KEY PERSON CONSIDERATIONS WHEN VALUING PRIVATE COMPANIES IN A GIFT AND ESTATE TAX CONTEXT

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In a gift and estate tax context, the valuation analyst may consider potential company dependence on one or two key individuals when estimating the value of a private company or an interest in a private company. This dependence is generally referred to as "key person risk," which is recognized within the valuation profession and by the U.S. Tax Court as a relevant company-specific risk characteristic. This company-specific risk characteristic can be accounted for in many ways within a valuation analysis for gift and estate tax purposes.

Introduction

In a closely held business and, specifically, a private company within a gift and estate tax context, the potential for there to be an individual who is largely responsible for (1) revenue generation, (2) customer interaction and development, (3) supplier interaction and development, (4) employee interaction and development, or (5) strategic vision development can be significant. The private company's dependence on this "key person" is generally referred to as "key person dependence" or, more commonly, "key person risk."

Key person risk in a gift and estate tax context is widely recognized in the valuation profession and by the U.S. Tax Court (the "Court") as a relevant company-specific risk attribute (including several historic Court decisions that recognized the existence and quantification of key person risk in the valuation of a closely held business or an interest in a closely held business). When valuing a closely held company for gift and estate tax purposes, the valuation analyst ("analyst") should (1) evaluate whether the subject company possesses any key person risk and (2) provide support for the level of any adjustment realted to key person risk.

Key Person Risk

Companies often are relatively small and may rely on a key person or two to ensure profitability. In these circumstances, it is important for the analyst to adequately consider the importance of these key person(s) and the potential risk to the business if they were to leave.

When valuing a private company ownership interest within a gift and estate tax context, the analyst should understand key person risk and be able to reasonably

evaluate the existence, or lack thereof, of this risk. This is because the private company:

1. may not have a formal transition plan to account for the potential loss of a key person,
2. may not have a noncompete agreement to insure the subject company against the loss of a key person, and/or
3. may not have life insurance payable to the subject company to account for the potential death or disability of a key person.

To account for this key person risk, the analyst may apply some type of discount (i.e., a "key person discount"). As presented in the International Glossary of Business Valuation Terms, a key person discount is defined as "an amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise."[1]

JUST BECAUSE A COMPANY IS "SMALL" IN TERMS OF REVENUE, ASSETS, OR EMPLOYEES DOES NOT NECESSARILY INDICATE THAT THE SUBJECT COMPANY OPERATES WITH KEY PERSON RISK.

The Court has allowed for a key person discount in estimating the value of a private company or an interest in a private company for gift and estate tax purposes when the existence of key person risk has been established. This key person discount is most often reflected as:

1. an explicit percentage discount at the enterprise (or equity) level before shareholder adjustment considerations,
2. an implicit adjustment to a discount or capitalization rate when estimating the value of a private company or an interest in a private company by applying the income approach, or
3. an implicit adjustment to the long-term management financial projections (discount cash flow method) or normalized long-term earnings (capitalization of net cash flow method) to account for the removal of the key person when estimating the value of a private company or an interest in a private company by applying the income approach.

The analyst may also apply an implicit adjustment to the selected market-derived pricing multiples when estimating the value of a private company by applying the market approach. As presented in the book *Business Valuation Discounts and Premiums*, "The impact or potential impact of the loss of a key person can be reflected either explicitly or implicitly. Sometimes the key person discounts may be reflected in an adjustment to a discount or capitalization rate in the income approach or to valuation multiples in the market approach. Alternatively, the key person discount may be quantified as a separate discount, sometimes as a dollar amount but more often as a percentage. It is generally considered to be an enterprise level discount (taken before shareholder level adjustments); it is a function of the valuation subject and impacts the entire company."[2]

Key Person Considerations

Being an owner or member of a private company does not automatically result in that individual being a key person. Further, just because a company is "small" in terms of revenue, assets, or employees does not necessarily indicate that the subject company operates with key person risk. In fact, a company may suffer little to no economic harm upon the departure of a key person if the subject company operating structure includes:

1. adequately trained employees who can effectively assume the responsibilities of the departing manager, owner, or founder; and
2. diversified revenue, supplier, and distribution sources that do not depend significantly on the departing manager, owner, or founder.

Small companies operating with a well-diversified senior management team capable of fulfilling the role of a departing key person are well-positioned to mitigate key person risk.

To analyze whether a private company has potential key person risk,the book *Business Valuation Discounts and Premiums* presents the following attributes of a key person that should be evaluated by the analyst:

1. Relationships with suppliers
2. Relationships with customers
3. Employee loyalty
4. Unique marketing visions, insight, and ability
5. Unique technical or product innovation capability
6. Extraordinary management and leadership skill
7. Financial strength (ability to obtain debt or equity capital or personal guarantees)[3]

For example, a key person may be able to obtain better prices or more exclusive products from suppliers based on the individual's reputation or personal relationships (item #1), or customers may want to purchase goods or services from a subject company because they have a personal relationship with a particular individual (or individuals) at the subject company (item #2).

Other examples include when strong loyalty exists between a company leader and certain employees of the subject company (item #3), when one person in the subject company has a uniquely successful marketing strategy (item #4), or when one person has the ability to understand the direction in which the relevant industry or products are moving to in the future (item #5).

Accounting for Key Person Risk in the Valuation of a Private Company

If key person risk associated with the private company to be valued has been identified by the analyst, the next steps typically include (1) quantifying the significance of the key person risk and (2) incorporating the financial impact of the key person risk in the valuation analysis of the private company or interest in a private company.

A brief discussion explaining the typical ways to capture key person risk when applying the market approach and the income approach follows.

Market Approach

Market approach methods rely on the principle that prices of securities of companies in the same or similar lines of business (compared to the subject private company, typically referred to as "guideline companies") provide informational value guidance to investors. Market approach methods typically incorporate a relational analysis between a sample of guideline company security trading prices, or transaction prices, and selected financial/operating fundamentals to create a range of relevant pricing multiples. These pricing multiples are then used as a basis for selecting certain valuation pricing multiples that can be applied to the same subject company financial fundamentals.

Key person risk typically can be incorporated in the market approach by adjusting down (i.e., decreasing) the selected guideline company market-derived valuation pricing multiples that are applied to the subject company to account for the subject company's level of key person risk. However, when adjusting these market-derived guideline company valuation pricing multiples, it is important that the analyst provide support for (1) decreasing the selected pricing multiples due to key person risk and (2) selecting the magnitude of the decrease of the selected pricing multiples.[4]

Income Approach

A number of income approach methods can be applied to estimate the value of a private company or an interest in a private company for gift and estate tax purposes. However, each method is fundamentally based on the principle that the value of an investment is a function of the income that will be generated by that investment over its expected life.

Within the income approach, two common methodologies can be used to incorporate key person considerations (i.e., a key person discount) in the valuation of a private company or an interest in a private company.

THE COURT HAS ALLOWED A VALUATION DISCOUNT IN ESTIMATING THE VALUE OF A PRIVATE COMPANY OR AN INTEREST IN A PRIVATE COMPANY WHEN KEY PERSON RISK HAS BEEN PROVEN TO EXIST.

The first methodology is for the analyst to increase the discount rate/capitalization rate used to estimate the present value of the normalized income stream for the subject company. The increase in the discount rate/capitalization rate is intended to reflect the incremental risk the key person dependency (i.e., key person risk) exerts on the subject company's ongoing operations.

The second methodology is for the analyst to estimate the projected detrimental effect that the loss of the key person would exert on the subject company's future operating results (i.e., the projected revenue and earnings used in a discounted cash flow analysis or a direct capitalization method analysis). The detrimental effect of the key person adjustment (i.e., the impact of the loss of the key person) would then be used to (1) normalize the subject company income and net cash flow used in the direct capitalization method analysis (based on the assumed loss of the key person) or (2) develop adjusted subject company long-term financial projections to be used in a discounted cash flow method analysis (based on the assumed loss of the key person).

Enterprise Level Discount

One additional option the analyst has in addressing key person risk in the valuation of a private company or an interest in a private company in a gift and estate tax context is to incorporate the relevant key person risk at the enterprise (or equity) level.

Rather than adjusting for key person risk in market multiples (market approach) or in company-specific risk premiums (income approach), the analyst can apply a dollar amount or a percentage adjustment to the indicated enterprise (or equity) value of the private company. The advantage of an enterprise (or equity) key person adjustment is that it does not require any reliance on management-prepared financial projections or attempts to estimate the subject company normalized earnings based on the assumed loss of the key person (income approach). It also does not require reliance on the comparability between guideline companies or justification for the level of the key person adjustments to the market-derived valuation pricing multiples (market approach).

Accounting for Key Person Risk and the Court

As mentioned, for gift and estate tax purposes, the Court has allowed a valuation discount in estimating the value of a private company or an interest in a private company when key person risk has been proven to exist. This is because the Court has recognized enterprise (or equity) level discounts for key person considerations. As presented in *Business Valuation Discounts and Premiums* (and regarding *Estate of Mitchell v. Commissioner*):

"Because (1) the court considered him a very key person, (2) alleged earlier offers to acquire the entire company were contingent upon his continuing service, and (3) there was a marked lack of depth of management, the court determined a 10 percent discount from the company's enterprise stock value."[5]

The Court's discussion of the key person risk is instructive:

"We next consider the impact of Mr. Mitchell's death on [John Paul Mitchell Systems]. Mr. Mitchell embodied JPMS to distributors, hair stylists, and salon owners. He was

vitally important to its product development, marketing, and training. Moreover, he possessed a unique vision that enabled him to foresee fashion trends in the hair styling industry. It is clear that the loss of Mr. Mitchell, along with the structural inadequacies of JPMS, created uncertainties as to the future of JPMS at the moment of death."[6]

This is an example of an enterprise (or equity) level key person discount. Although there is a degree of judgment in the application of a key person discount, it is helpful from an analyst point of view to at least be able to rely on certain court decisions as support for an enterprise (or equity) level key person discount. The Court decision in *Estate of Yeager v. Commissioner* is another example (where the Court determined a 10 percent enterprise or equity level key person discount):

"Until his death, the decedent was president, chief executive officer, and a director of Cascade Olympic, Capital Cascade, and Capitol Center. He was the only officer and director of these corporations who was involved in their day-to-day affairs. The decedent was also president of Center Offices until 1979. The presence of the decedent was critical to the operation of both Cascade Olympic and the affiliated corporations."[7]

Conclusion

Key person considerations are important when valuing a private company or an interest in a private company in a gift and estate tax context. Thankfully, the Court has provided guidance to assist the analyst in estimating and supporting a reasonable key person discount for gift and estate tax purposes.

IT IS HELPFUL FROM AN ANALYST POINT OF VIEW TO AT LEAST BE ABLE TO RELY ON CERTAIN COURT DECISIONS AS SUPPORT FOR AN ENTERPRISE (OR EQUITY) LEVEL KEY PERSON DISCOUNT.

Overall, best practices suggest that the analyst:

1. complete sufficient due diligence procedures to establish whether a subject company has key person dependency,
2. identify the key person risk and incorporate these elements into the valuation process that properly address the economic impact of the identified key person dependency, and
3. provide significant support for the selected key person risk adjustments.

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References:

1 International Glossary of Business Valuation Terms (as adopted by the American Society of Appraisers, 2009).

2 Shannon P. Pratt, *Business Valuation Discounts and Premiums*, 2nd ed. (New York: John Wiley & Sons, 2009), 261.

3 Ibid., 260-261.

4 An issue when incorporating a key person adjustment in the market approach is the significant degree of judgment or subjectivity related to the adjustment. Because it may be difficult to provide objective, quantifiable support for each adjustment to the guideline company market-derived valuation pricing multiples, it is relatively uncommon to incorporate key person risk considerations when applying the market approach to value a private company or an interest in a private company.

5 Pratt, *Business Valuation Discounts*, 266.

6 Ibid.

7 Ibid., 232.