**Caracci and the Valuation of Exempt Organizations**

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**ABSTRACT:** In *Caracci v. Commissioner*, the Internal Revenue Service faced an important test in its application of Excess Benefit Taxes to disqualified persons of a nonprofit corporation that converted to for-profit status. This Article, written by the taxpayers’ valuation expert, details the difficulties in the IRS case and demonstrates the reasons for the Fifth Circuit’s reversal of the Tax Court’s judgment in favor of the IRS. The author concludes with a number of lessons that taxpayers can take from *Caracci*.

In July of 2006, the United States Court of Appeals for the Fifth Circuit reversed the Tax Court’s decision in *Caracci v. Commissioner* and held against the Internal Revenue Service (IRS) on the issue of liability for Excess Benefit Taxes imposed on the sale of charitable assets to a for-profit entity.1 “Excess benefit” transactions are those in which the fair market value of the assets transferred by a tax-exempt organization2 exceeds the consideration rendered.3

For many years prior to 1996, the IRS was severely constrained in its efforts to discipline exempt organizations. Its only real weapon to fight corruption in the charitable sector was full revocation of an organization’s exempt status. A year after the CEO of United Way was sentenced to prison for fraud and insider profiting,4 however, Congress enacted Section 4958 of the

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1 Caracci v. Comm’r, 456 F.3d 444, 447 (5th Cir. 2006); Caracci v. Comm’r, 118 T.C. 379, 420 (2002).
Internal Revenue Code (IRC), which outlines a series of potential taxes and penalties directed towards disqualified\(^5\) individuals of exempt organizations that are found to have engaged in an excess benefit transaction.\(^6\) Section 4958 provides an “intermediate” solution between the extreme courses of action previously available to the IRS.\(^7\)

In 2001, nearly five years after Congress promulgated Section 4958, the IRS brought the first action regarding an excess benefit transaction under the statute: Caracci v. Commissioner.\(^8\) The central issue before the Tax Court was determining the fair market value of the unprofitable assets of Sta-Home Health Agency (Sta-Home), an exempt home healthcare agency doing business in rural Mississippi.\(^9\)

In its May 2002 opinion, the Tax Court put forth a framework, valuation, and findings that confirmed the IRS’ claim: upon conversion to nonexempt status, the Sta-Home for-profit entities received tangible and intangible assets with a fair market value of over \$18.5\ million and assumed liabilities totaling roughly \$13.5\ million, thereby conveying to shareholders excess benefits of approximately \$5.1\ million.\(^10\) To arrive at these findings, the Tax Court used a valuation framework based on a financial theory never previously used by a court or valuation treatise to value assets. The Tax Court relied upon a single valuation indicator drawn from “comparable” companies to establish a theoretical market value for Sta-Home’s deficient capital structure.\(^11\) The Tax Court then “plugged” a value for Sta-Home’s intangible assets to arrive at a determination of excess benefits.\(^12\) This framework did not require consideration of a single tangible or intangible asset or liability of Sta-Home.

\(^5\) A person is disqualified as to an applicable tax-exempt organization if the person was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the excess benefit transaction (the “Lookback Period”), but not before September 14, 1995. Reg. 53.4958-3(a)(1).


\(^8\) Caracci, 118 T.C. 379.

\(^9\) Id. at 382, 390–91.

\(^10\) Id. at 413.

\(^11\) Id. at 398, 404.

\(^12\) See id. at 410, 413.
In July 2006, the Fifth Circuit reversed the Tax Court’s findings of excess benefits, pointing to several “factual and legal errors,” including failure to consider many of the key elements of fair market value as outlined in Rev. Rul. 59–60. The Fifth Circuit found that the Tax Court erred as a matter of law in selecting the method to value Sta-Home’s intangible assets and made clear errors of fact in applying the valuation method. The court of appeals corrected many of the Tax Court’s errors, omissions, and oversights, finding that the total assets of Sta-Home did not exceed the liabilities assumed by the exempt entities.

The taxpayer’s appeal of the Tax Court’s ruling in Caracci v. Commissioner has been viewed by the legal community as an early test of Section 4958 authority by the IRS. In addition to the legal implications of the reversal, the Fifth Circuit decision is a sharply worded reminder to appraisers of the importance of using the appropriate valuation framework when valuing a business interest in a private company.

I. History of Sta-Home’s Tax-Exempt Organization Status

The Sta-Home Health Agency consisted of three nonprofit, tax-exempt home healthcare organizations. The Caracci family (the taxpayers) began Sta-Home in 1976 to provide traditional home healthcare services in a large and predominantly rural part of Mississippi. Because central and western Mississippi (including the Delta) historically have been impoverished, home healthcare in Mississippi has traditionally been dependent upon Medicare. Sta-Home received 95-97% of its annual revenue in the form of cost reimbursement from the Medicare program.

When Joyce and Victor Caracci first formed Sta-Home, Medicare regulations required that participating home healthcare agencies either be licensed under state law or formed as tax-exempt entities under IRC Section 501(c)(3). At the time, Mississippi

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13 Caracci v. Comm’r, 456 F.3d 444, 447, 461 (5th Cir. 2006).
14 Id. at 461–462.
15 Id. at 462.
17 Caracci, 118 T.C. at 382.
18 Caracci, 456 F.3d at 447.
19 Caracci, 118 T.C. at 386.
20 Caracci, 456 F.3d at 458.
21 Id. at 448; Broccolo et al., supra note 16, at 3.
law provided no licensing procedure, so the Medicare regulations effectively required Sta-Home to initially organize as an exempt entity.22

In 1980, Congress passed the Medicare and Medicaid provisions of the Omnibus Budget Reconciliation Act of 1980 (OBRA ’80).23 Those provisions eliminated the Medicare requirement that home healthcare agencies operate as tax-exempt entities.24 Thereafter, almost all of the Mississippi home healthcare agencies converted from exempt to nonexempt status.

The Caraccis were advised that they, too, needed to convert Sta-Home to nonexempt status because of the deterioration of the agency’s financial condition.25 Prior to conversion, Sta-Home had a five year record of unprofitable operations and a growing fund deficit that totaled $1.4 million,26 as shown in Table 1.27

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Annual Revenue</th>
<th>Net Income (Loss)</th>
<th>Total Assets</th>
<th>Total Liabilities</th>
<th>Fund Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>18,442,072</td>
<td>27,757</td>
<td>5,404,925</td>
<td>5,960,696</td>
<td>(555,771)</td>
</tr>
<tr>
<td>1993</td>
<td>25,162,701</td>
<td>(45,554)</td>
<td>6,910,710</td>
<td>7,639,855</td>
<td>(729,145)</td>
</tr>
<tr>
<td>1994</td>
<td>36,882,957</td>
<td>(258,729)</td>
<td>7,515,492</td>
<td>8,417,027</td>
<td>(901,535)</td>
</tr>
<tr>
<td>1995</td>
<td>44,101,849</td>
<td>(433,390)</td>
<td>10,736,407</td>
<td>12,144,655</td>
<td>(1,408,248)</td>
</tr>
</tbody>
</table>

Sta-Home’s lack of access to capital and accumulated losses resulted in cash flow shortages. To maintain operations, Sta-Home was forced to use unconventional funding practices to support its working capital requirements.28 Several financial experts questioned the “going concern” status of Sta-home throughout the investigation into its fair market value.29

22 Broccolo et al., supra note 16, at 3.
24 See Caracci, 456 F.3d at 448.
25 Caracci, 118 T.C. at 387.
26 Id. at 385.
27 Id. at 385 tbls.
28 See id. at 406.
29 Id. at 400.
II. Sta-Home’s Conversion to Nonexempt Status

For several years prior to Sta-Home’s conversion on October 1, 1995, advisory boards had been testing a revised Medicare payment mechanism to reimburse the home healthcare industry. A new payment system was needed to cut Medicare’s operating cash requirements. Under the then-prevailing cost-based reimbursement system, Sta-Home and other agencies received a check every two weeks for services estimated by a Medicare formula. Under Medicare’s anticipated payment system, home healthcare agencies would be required to file a claim for services rendered and wait for that claim to be processed. This delay in claims processing meant Sta-Home would require greater access to cash to support its operations. Sta-Home was already forced to fund current working capital requirements through accruals and deferred payroll payments. Sta-Home’s management was very concerned about the greater working capital demands a prospective payment system would place on the agency and the needed capital to transition to this type of payment system.

Access to capital required a change in legal status. OBRA ‘80 resulted in an exodus from exempt status among Mississippi home healthcare agencies, thereby creating a niche for reliable businesses (i.e., government-funded) that needed working capital lines of credit. Financial institutions were influential in maintaining liquidity for many home healthcare agencies in Mississippi; however, local bankers were reluctant to loan money to exempt entities. After exhausting its options to access capital and stabilize its financial prospects, Sta-Home converted into nonexempt corporations. At the time of conversion, members of the Caracci family served both as directors of Sta-Home and

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30 Caracci, 118 T.C. at 388.
32 Caracci, 118 T.C. at 383.
33 Caracci v. Comm’r, 456 F.3d 444, 448 (5th Cir. 2006).
34 Caracci, 118 T.C. at 385.
35 Id. at 386.
37 Caracci, 118 T.C. at 386–87.
38 Caracci, 456 F.3d at 449–50.
sole shareholders of the for-profit corporations that were established to receive the assets and liabilities of Sta-Home.\textsuperscript{39}

### III. The IRS’ Excess Benefit Transaction Claim Against Sta-Home

After the conclusion of an unusually long audit of the agency in 1999, the IRS determined that the value of Sta-Home’s tangible and intangible assets actually “exceeded the value of the liabilities and debts assumed [upon conversion] by approximately $18.5 million.”\textsuperscript{40} The IRS arrived at this finding despite Sta-Home’s five-year record of unprofitable operations and an equity deficit of $1.4 million immediately prior to conversion.\textsuperscript{41} The IRS’ estimate of fair market value regarded Sta-Home as a valuable going concern business despite its financial condition.\textsuperscript{42}

The IRS issued valuation-based Notices of Deficiency (the “Notices”) asserting Section 4958 excise tax penalties against the Caraccis totaling more than $250 million and retroactively revoking the exempt status of Sta-Home.\textsuperscript{43} The Notices were based on the IRS’ belief that the Caraccis had received a net excess benefit of over $18.5 million from the conversion of Sta-Home to nonexempt status.\textsuperscript{44}

Mistakenly, the Notices and tax penalties issued to the Caraccis only reflected the estimated fair market value of Sta-Home’s assets.\textsuperscript{45} The value of the liabilities assumed by the for-profit corporations upon conversion, determined to be $13.5 million, was excluded from the IRS’ calculations.\textsuperscript{46} Still, the IRS asserted that even after the $13.5 million in liabilities were netted against its fair market value estimate of $18.5 million for Sta-Home’s assets, the shareholders received excess benefits of approximately $5.1 million from the conversion of Sta-Home.\textsuperscript{47}

Under Section 501(c)(3) of the IRC, an exempt organization holds assets for the benefit of the public, and upon conversion, a willing buyer will receive these assets and must pay fair market

\textsuperscript{39} Caracci, 118 T.C. at 387–88.  
\textsuperscript{40} Caracci, 456 F.3d at 450 (emphasis added).  
\textsuperscript{41} Id. at 448.  
\textsuperscript{42} Caracci, 118 T.C. at 400, 403.  
\textsuperscript{43} Caracci, 456 F.3d at 450.  
\textsuperscript{44} Id.  
\textsuperscript{45} Id.  
\textsuperscript{46} Id. at 451.  
\textsuperscript{47} Caracci, 118 T.C. at 413.
Neither the IRS nor the Caraccis challenged the estimated fair market value of Sta-Home’s tangible assets. The IRS took issue with the existence and value of intangible assets, asserting that these assets had significant value given that Sta-Home was a “recognized name in home healthcare” with accredited high standards. In a not-for-profit conversion transaction, individuals cannot personally remove the intangible value created by their efforts without paying full fair market value.

IV. The Tax Court’s Flawed Valuation Framework

On May 22, 2002, Judge David Laro of the Tax Court found that the shareholders of the newly formed nonexempt corporations received assets in excess of liabilities assumed, and determined that a “willing buyer would assume $13.5 million in liabilities and pay $5.1 million to acquire” the rights to Sta-Home’s intangible assets. The Tax Court rejected much of the evidence presented by the Caraccis and the IRS’ valuation experts and, instead, selected information in the administrative record to piece together its own valuation framework.

The Tax Court’s valuation framework was premised on the mistaken belief that Sta-Home possessed unilateral power to reap profits:

The Sta-Home tax-exempt entities reported a modest income from operations, but, after deducting interest and depreciation (mostly for their fleet of...
automobiles), they reported a loss of $506,713. Although in 1995 they also reported an increase for the third consecutive year in the negative net asset value to a new total of $1,408,248, the evidence shows that their fourth employee bonus in that year amounted to some $2,314,086. Had they not declared that bonus, they would have reported nontaxable income of approximately $1,785,000, or, in other words, more than enough to eliminate the accumulated deficit in net asset value.\(^{53}\)

The Tax Court misunderstood the fundamental feature of Sta-Home as a Medicare-dependant business: no home healthcare agency receives reimbursement revenue unless it incurs the necessary patient expense. If Sta-Home chose not to pay a bonus to its workforce, then its revenue reimbursement would also be reduced by the amount of the unpaid bonuses. Under the Tax Court’s mistaken beliefs, Sta-Home could have unilaterally created $1.78 million in profits through an imagined sequence of non-events that would have constituted Medicare fraud—and legal, but economically unprofitable, intangible rights would have significant value.\(^{54}\) These fallacies led the Tax Court to construct an inappropriate valuation framework. Even the IRS’ valuation expert acknowledged that the Tax Court’s determination of excess benefits was the result of a plugged number.\(^{55}\)

The Tax Court borrowed an analysis from the IRS’ valuation expert that used the market prices of publicly traded debt and equity securities, collectively referred to as market value of invested capital (MVIC), to value the assets of a 501(c)(3) organization.\(^{56}\) The underlying idea advanced by the Tax Court is that once MVIC is established, accounting principles could be used to infer the fair market value for Sta-Home’s net assets.\(^{57}\)

\[^{53}\text{Caracci, 456 F.3d at 456.}\]
\[^{54}\text{An appraisal performed for domestic tax purposes should adhere to the valuation guidance provided by Rev. Rul. 59-60. See Rev. Rul. 59-60, 1959-1 C.B. 237. Under the IRC, “[t]he presence of goodwill and its value” depends “upon the excess of net earnings over and above a fair return on the net tangible assets.” Id.; see Rev Rul. 68-609, 1968-2 C.B. 327. Sta-Home could not make excess return under a cost-based payment system and, therefore, could not possess any goodwill or going concern value beyond that ascribed to the identifiable intangible assets as of the date of conversion. See Caracci, 456 F.3d at 461.}\]
\[^{55}\text{Caracci, 456 F.3d at 459–460, 461.}\]
\[^{56}\text{Caracci, 118 T.C. at 405.}\]
\[^{57}\text{Id.}\]
Generally Accepted Accounting Principles (GAAP) define a balance sheet as a company’s “assets, liabilities, and shareholders’ equity.”\(^58\) Assets are economic resources that have the ability or potential to provide future economic benefits to the enterprise.\(^59\) The liabilities and shareholders’ equity represent respective claims on the benefits provided by those assets.\(^60\) A company’s GAAP balance sheet reflects the accounting identity: \(\text{Total Assets} = \text{Total Liabilities} + \text{Owners’ Equity}\).\(^61\)

From the perspective of the market, this identity is not circu-itious. As a going concern, the net assets of an enterprise generate economic benefits for its stakeholders. The market value of a company’s debt and equity securities is derived from, but does not determine, the fair market value of its asset base. “[A]rguably, the most fundamental business valuation principle is this: The current value of assets minus the current value of liabilities equals the current value of owners’ equity. This formula is an economics identity.”\(^62\)

Therefore, the appropriate expression to measure excess benefits, if any, in a not-for-profit conversion transaction is Market Value of Net Assets – Market Value of Total Liabilities = Equity Value.\(^63\) Because the claims of common shareholders are typically junior in status, equity is considered a residual value as shown in Figure 1.

**Figure 1**

“Hypothetical” Fair Market Value Balance Sheet

<table>
<thead>
<tr>
<th>Enterprise Value (net assets)</th>
<th>Shareholder Claims (MVIC)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Working Capital</td>
<td>Long-term Liabilities</td>
</tr>
<tr>
<td>Depreciable Assets</td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>Equity Value (residual)</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td></td>
</tr>
</tbody>
</table>

\(^{59}\) Id. at 793.
\(^{60}\) Id. at 7.
\(^{61}\) Id. at 8.
\(^{63}\) See JOHN D. STOWE ET AL., ANALYSIS OF EQUITY INVESTMENTS: VALUATION 116 (2002).
A company’s MVIC varies with the ability of its net assets to produce income for the enterprise. As such, capital structure decisions often reflect the unique characteristics of the net assets. Publicly traded companies generally maintain a high proportion of income producing assets that support positive debt ratings and equity values in the capital markets. The value of these assets often allows management substantial flexibility in choosing funding sources for the enterprise. In contrast, Sta-Home was comprised exclusively of unprofitable assets that resulted in operating losses totaling $1.4 million. Sta-Home had no access to capital. Instead, Sta-Home management funded cash flow needs through employee and vendor payables, which were more than 1.13 times greater than its recorded assets.

By equating the MVIC of a publicly traded company to the liability structure of a distressed private company with a deficient capital account, the Tax Court’s valuation framework resulted in the theoretical equivalent of recapitalizing Sta-Home with a normalized debt and equity capital structure and injecting substantial income generating characteristics into otherwise unprofitable assets. As shown in Figure 2, the difference between the determination of MVIC by the Tax Court, and Sta-Home’s net asset accounting value is the intangible assets to which the Tax Court assigned a balancing entry, or plugged value.

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Figure 2
Tax Court Valuation Framework

![Diagram showing the relationship between MVIC, Net Assets, Intangible Assets, Debt and Equity Capital, and Accounting Value.]

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64 See id. at 117.
65 Caracci v. Comm’r, 456 F.3d 444, 448 (5th Cir. 2006).
66 See id. In audited Sta-Home financial records from 1995, it was shown that Sta-Home’s recorded assets were $10,736,407 and its total liabilities were $12,144,655. As such, Sta-Home’s recorded liabilities were 13.1% greater than its assets (on file with author).
67 See id. at 459.
By mixing the valuation concepts embodied in an MVIC approach with the accounting principles recognized under GAAP, the Tax Court created a framework by which substantial value could be ascribed to, or “plugged” for Sta-Home’s intangible assets. The Tax Court attempted to support its finding on a false premise: that all companies operating in the home healthcare industry possess similar economic intangible assets. Sta-Home was captive to its geographical location, patient base, and primary payor—Medicare; its financial constraints could not support the existence of substantial intangible asset value. Under the standard of fair market value contained in Revenue Ruling 59-60, a valuation must realistically reflect what price a willing buyer would actually pay for the property, rather than resort to a theoretical value extracted from “over-engineering.”

V. An Appeal for Reason

On appeal, the Fifth Circuit was faced with a stark question: What would an arm’s length buyer actually pay on the date of conversion for the intangible right to lose money? The Tax Court’s findings of excess benefits in Sta-Home’s conversion transaction of $5.1 million were a glaring contrast to several contemporaneous and retrospective appraisals of the agency that concluded Sta-Home’s liabilities were greater than its assets at conversion. One of these appraisals was rendered by an accounting firm used by the federal government to audit home healthcare agency cost reports; another was by the author, characterized by the Fifth Circuit as a recognized “industry expert” who both parties attempted to retain to provide expert valuation testimony. How, then, were the IRS and Tax Court able to reach a positive valuation conclusion when industry and valuation experts provided contrary appraisals?

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68 Id. at 458–59.
69 Estate of Dunn v. Comm’r, 301 F.3d 339, 358 n.36 (5th Cir. 2002).
70 Caracci, 456 F.3d at 447, 459.
71 Id. at 449, 451. Three appraisals produced by the Caraccis concluded that the liabilities of Sta-Home exceeded its tangible and intangible assets, suggesting the potential for insolvency. Id. at 449. The IRS’s expert questioned Sta-Home’s management on plans to liquidate the business after their review of historical financial performance indicated “the Company reported operating losses in the periods immediately preceding the Valuation Date, and an accumulated deficit as of the Valuation Date.” See Bobbie J. Jenkins & Charles A. Wilhoite, Sta-Home Home Health Agency, Inc., Jackson & Affiliated Companies Fair Market Value as of October 1, 1995, at 6, Willamette Management Associates (Portland, Or., Jan. 2001) (on file with author).
72 Caracci, 456 F.3d at 451.
The Tax Court’s framework created an intangible asset on Sta-Home’s balance sheet by relying on publicly traded “comparable” companies to draw a relative value conclusion. The reliability of a market model depends upon the ability to identify companies with similar value characteristics. The value characteristics of publicly traded companies are often quite different than those of closely held businesses, including depth of management, access to capital, business risk, growth rate, capital structure, and the size and timing of cash flows.73

Public companies typically have operations spanning a broader range of products and services than do private companies. The Tax Court’s opinion noted that Sta-Home did not offer many of the services provided by publicly traded home healthcare agencies including “the more sophisticated, and remunerative, home healthcare techniques, such as infusion and respiratory therapies.”74 Recent studies have shown that, on average, private companies are acquired at a 20-30% discount relative to similar public companies when earnings multiples are used to value the transactions.75

However, simply adjusting observed market multiples to compensate for otherwise dissimilar comparables is not sufficient to arrive at a valid conclusion of value. In this instance, Sta-Home operated with profit restrictions due to its substantial Medicare patient base and had a long-term history of financial losses. Any adjustment from a public company multiple for these attributes would be purely conjecture. In Estate of Dunn v. Commissioner, the Fifth Circuit Court of Appeals recognized that a public company multiple approach is inappropriate when a closely held business is not comparable to other corporations engaged in a similar business.76

Despite recognizing that few (if any) truly comparable characteristics existed between the public companies and Sta-Home, the Tax Court nevertheless relied entirely on a public market approach in constructing its valuation framework. The publicly traded comparable companies used by the Tax Court had capital, access to public market funding, and were selling at prices that necessarily reflected positive equity. Selecting a universe that

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73 See id. at 459.
75 John Koeplin et. al., The Private Company Discount, 12 J. APPLIED CORP. FIN. 94, 95 (2000).
76 Estate of Dunn v. Comm’r, 301 F.3d 339, 350 (5th Cir. 2002).
consisted exclusively of publicly traded participants with capital and positive equity led the Tax Court to infer substantial value for Sta-Home’s assets by inappropriately mixing valuation and accounting conventions. The Tax Court’s framework made it mathematically impossible to calculate a negative net asset value for a financially distressed, private company like Sta-Home.

VI. Valuation Lessons from the Court of Appeals

In July 2006, the Fifth Circuit reversed the Tax Court’s decision in Caracci v. Commissioner, finding “the Tax Court made a number of errors in the valuation method it selected and in the facts it found in selecting and applying that method.”77 The Fifth Circuit’s discussion of the Tax Court’s valuation analysis offers several important lessons to appraisers and attorneys advising exempt organizations on business transactions.

A. Lesson 1: Define the Business Interest or Interests to be Appraised

Due to the tax status of a 501(c)(3) organization, the sale of an exempt business is usually a transfer of assets, although certain complex transaction structures may instead require the transfer of a residual interest. The identification of the correct business interest to be valued is fundamental to constructing an appropriate framework and choosing the valuation approach. The relevant property to be valued in the Sta-Home conversion transaction was the identified tangible and intangible assets of the exempt organization. The Tax Court used an approach that measures the value of debt and equity securities or MVIC. The Tax Court’s assumption about a “normalized” capital structure for Sta-Home created new value characteristics, such as liquidity, ownership status, and voting rights that were not attributes of the exempt entity.78

As the Supreme Court has recognized, “[t]he capital stock of a corporation, its net assets, and its shares of stock are entirely different things . . . . The value of one bears no fixed or necessary relation to the value of the other.”79 Thus, the sum of values of partial interests may or may not add up to the value of the enterprise taken as a whole. A stakeholder has no direct claim to a corporation’s assets, only to its residual income or free cash flow

77 Caracci, 456 F.3d at 458.
to the firm (FCFF); a legal entity intervenes between the assets of a corporation and its stakeholders. Because of this separation, there are many elements of a company’s capital structure that can enhance or detract from the value of a direct interest in the FCFF of the enterprise including senior, junior, or residual claim status; restrictive agreements; dispute resolution processes; and distribution of ownership. From a market perspective, control buyers usually analyze assets in aggregate for strategic purposes; stakeholders generally emphasize earnings and liquidity accruing to their ownership interest. Due to these significant differences, MVIC of a publicly traded company often bears little or no relationship to the net asset value of a private company. The court of appeals determined that value measurement was inconsistent with the property transferred, ruling that the “MVIC-Revenue method for valuing Sta-Home’s assets, particularly its intangible assets, is wrong as a matter of law.”

B. Lesson 2: The Valuation Model Must Match the Purpose of the Transaction

The court of appeals determined that a direct method of valuing the relevant property is the legal basis for measuring excess benefits in a 501(c)(3) conversion transaction. Unlike the MVIC approach used by the Tax Court to assign values to all of Sta-Home’s assets in general without valuing any of Sta-Home’s assets in particular, the court of appeals agreed with the testimony of both valuation experts that a direct examination of all the components (i.e., assets and liabilities) that determine equity value is the “preferred and more rigorous approach.” This approach implies that in most 501(c)(3) conversion transactions the appraiser should use either a discounted cash flow (DCF) or an adjusted balance sheet (ABS) model to estimate value.

DCF models define the value of an asset as the present or discounted value of its expected future cash flows. Present value models such as DCF are regarded in academic finance theory as the fundamental approach to valuation. The logic of these models is that the value of an asset to an investor must be related to the returns that investor expects to receive from holding that asset. In most 501(c)(3) transactions in which income generating assets are being exchanged, a DCF model will likely be

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80 Caracci, 456 F.3d at 458.
81 See id.
82 Id. at 461.
83 Stowe et al., supra note 63, at 114.
84 Id. at 40.
an appropriate technique to consider in developing an overall opinion of fair market value.

DCF models require a forecast of expected future cash flows and the development of a terminal value for cash flows that will continue beyond the forecast horizon. The proper definition of cash flow in the context of most 501(c)(3) conversion transactions should be free cash flow. FCFF is the cash flow generated by the assets of the business “after all operating expenses (including taxes) have been paid and necessary investments in working capital (e.g., inventory) and fixed capital (e.g., equipment) have been made.” On the statement of cash flows contained in a company’s audited financial statements, FCFF is the cash flow from operations minus capital expenditures. The advantage of FCFF is that it can be used in a DCF framework to value the enterprise; other earnings measures such as net income, earnings before interest and taxes (EBIT), or earnings before interest, taxes, depreciation and amortization (EBITDA) do not have this property because they all omit cash flows in some manner.

To calculate the fair market value using a DCF model, a discrete measure of FCFF must be developed for each period over an appropriate forecast horizon, typically in annual increments. At the end of the forecasting period, a residual value is computed based on the assumption that normalized FCFF will continue into perpetuity. These cash flows are discounted to present value using a discount rate that incorporates both the time element and the risk-return characteristics of the income stream generated by the enterprise. Since this definition of FCFF is also equivalent to the economic benefits available to stakeholders of the enterprise, the weighted average of the cost of equity and after-tax cost of debt (collectively, “WACC”) is the appropriate discount rate to use in this model. By discounting to present projected annual net cash flows and the terminal value by the WACC, an estimate of the fair market value of net assets is obtained. In this context, a DCF model measures the fair market

85 STOWE ET AL., supra note 63, at 115.
86 Id.
87 See BREALY AND MYERS, PRINCIPLES OF CORPORATE FINANCE 64 (1991). A common method of calculating the value of an asset with an infinite lifetime requires a present value estimate of the remaining future cash flows beyond the finite forecast horizon. This terminal value is typically developed using a single stage or multistage FCFF growth valuation model. For a discussion of FCFF valuation models, see STOWE ET AL., supra note 63, at 114–56.
88 See STOWE ET AL., supra note 63, at 114-156.
value of the enterprise as the present value of future FCFF discounted by the WACC:89

\[
\text{FCFF}_t \over (1 + \text{WACC})^t
\]

A DCF model recognizes the uniqueness of the business interest being valued. Its fundamental difference from a market model is the ability to individually quantify many operating assumptions and consolidate them into an evaluation of the enterprise. An advantage of using a DCF model to directly measure the economic benefits of the enterprise is that a discount for a lack of marketability and/or a premium for control are not required.

The adjusted balance sheet (ABS) model is also a direct asset valuation method. This approach involves the identification and valuation of otherwise unrecorded tangible and intangible assets and liabilities, if any, as well as the revaluation of the asset and liability accounts recorded on the company’s historical cost-based balance sheet.90 In contrast to aggregate FCFF in a DCF model, the ABS model requires inspection and valuation of the individual components of the enterprise: working capital, personal property, intangible assets, going concern, and goodwill value, if any.91 ABS models are useful in conversion transactions that include a “carve out” of assets from the enterprise or in regulatory hearings when the value of a specific class or asset is at issue (e.g., intangible assets or goodwill value).

An ABS model typically requires use of all three general approaches to valuation (cost, market, and income) to estimate the fair market value of the enterprise. When the ABS model is applied generally to a subset of assets, cash, and prepaid expenses remain at historical cost value; land, inventory and marketable securities are valued based on a sales comparison or market approach; values of buildings and improvements, office furniture, and fixtures are typically based on depreciated reproduction cost; and intangible assets such as advantageous supply contracts, customer relationships, trade names, and goodwill value lend themselves to an income approach. Similar to the asset base, the liabilities are all reassessed using the appropriate approach for the characteristics of each obligation. The value of the individually appraised assets less the value of

89 STOWE ET AL., supra note 63.
91 See id. at 396–97.
the individually appraised liabilities represents the fair market value of the equity of the enterprise.\textsuperscript{92}

If the ABS model has been properly applied, the fair market value of the business enterprise represents what a willing buyer would pay for a one hundred percent claim on the assets of the enterprise. Again, no adjustments for a lack of marketability or control rights are necessary with this type of valuation model. In one of the few tax court opinions weighing the value of a not-for-profit’s assets, the \textit{Anclote Psychiatric} court relied upon the ABS model to develop a determination of fair market value.\textsuperscript{93}

\textbf{C. Lesson 3: “Comparable” Means “Comparable”}

When guideline companies are used to determine a value through relative transaction analysis, the court’s decision in \textit{Caracci} reaffirms the need to be aware that there are numerous value differences between private and public companies. Put simply, the seven public companies the Tax Court used were not comparable to Sta-Home.\textsuperscript{94}

Although some courts use a broader interpretation of “comparable,” choosing between public companies that are similar and those that are not closely related is a critical exercise in formulating an appropriate valuation approach. In the process of rendering an opinion of fair market value, \textit{Uniform Standards of Professional Appraisal Practice} (USPAP) requires a thorough and objective search for guideline companies to establish the credibility of the valuation analysis.\textsuperscript{95}

Assessing the effectiveness of using a group of public comparables requires a detailed analysis and synthesis of business characteristics including, but not limited to, total revenue or asset size, line(s) of business, payor mix, nature of competition, geographic diversification, margins, profits, growth rates, and capital structure and leverage. While no single indicator can define the comparability of companies, the value of a business does depend upon the future benefits that will accrue to its owners. Since the introduction of a prospective payment system in the home healthcare industry, economic benefits are defined

\textsuperscript{92} See \textit{Caracci}, 118 T.C. at 396–97.
\textsuperscript{93} Anclote Psychiatric Ctr. v. Comm’r, 76 T.C.M. (CCH) 175 (1998).
\textsuperscript{94} Caracci v. Comm’r, 456 F.3d 444, 458 (5th Cir. 2006).
\textsuperscript{95} See Gross v. Comm’r, 78 T.C.M. (CCH) 201, 204 (1999). The Appraisal Standards Board (ASB) of The Appraisal Foundation develops, interprets, and amends the USPAP, which represent the generally accepted and recognized standards of appraisal practice in the United States.
by willing buyers in terms of profitability, not by the capacity to shift overhead costs or total payroll. Therefore, an examination of a company’s profitability, either defined as EBITDA or EBIT, is a key consideration in the selection process.\footnote{See Stowe et al., supra note 63, at 132.}

Many court decisions have rejected attempts to establish public companies as “comparable” due to the appraiser’s failure to adequately consider some or all of the above factors. These factors are also set forth with additional guidance in Rev. Rul. 59-60.\footnote{Rev. Rul. 59-60, 1959-1 C.B. 237.} The vast differences between the characteristics of publicly traded companies and Mississippi home health companies clearly did not lend themselves to using public companies as comparables to determine Sta-Home’s fair market value. The Fifth Circuit emphasized that “[a] ‘comparable’ must be substantially similar to the entity or asset that is at issue”\footnote{Caracci v. Comm’r, 456 F.3d 444, 459 (5th Cir. 2006) (citing Van Zelst v. Comm’r, 100 F.3d 1259, 1263 (7th Cir. 1996)); Estate of Palmer v. Comm’r, 839 F.2d 420, 423 (8th Cir. 1988)).} for it to be useful in a market approach to valuation.

The Fifth Circuit found the private company acquisition data presented by the author to be more relevant, noting the substantial valuation differences between home healthcare agencies located in Mississippi and those that are publicly traded. The acquisition data available on one hundred percent controlling-interest asset acquisitions of traditional, private home healthcare companies located in Mississippi was available and already reflected the unique characteristics of home healthcare agencies in the geographic region.\footnote{See Caracci v. Comm’r, 118 T.C. 379, 390 (2002).} The strengths of private company acquisition data are that these acquisitions are almost always acquisitions of an entire entity with fiscal similarities to the subject company being valued. Thus, these data can be used in either a primary or secondary valuation approach, depending on the quantity and quality of the information. In contrast, the pool of publicly traded companies used by the IRS and the Tax Court were too dissimilar to Sta-Home to serve as the basis for a stand-alone valuation. Under the standard of fair market value, the valuation method must take into account, and correspond to, the attributes of the entity whose assets are being valued.

**D. Lesson 4: Appropriate Synthesis of a Value Conclusion**

The Tax Court’s determination of fair market value was the result of one valuation approach and a single MVIC-Revenue market

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\footnote{1}{See Stowe et al., supra note 63, at 132.}
multiple. The Tax Court was certain this outcome was correct and did not consider any alternative valuation approaches or outcomes. In the process, the Tax Court disregarded evidence that did not corroborate the MVIC-Revenue valuation result, including market multiples of income (EBITDA, earnings, and cash flow) and private market conversion transactions in Mississippi. It is generally recognized that the fair market value of a private business is a range concept. If valuations are conducted properly, alternative valuation methods typically yield value estimates in a reasonably tight range. Point estimates drawn from alternative approaches provide mutually supportive evidence from which to form the valuation synthesis and conclusion. When an outlier estimate of value is observed, USPAP require a full explanation of the anomaly.

Rather than forming a value conclusion from multiple approaches, the Tax Court proceeded with a single valuation approach that the court of appeals rejected as “not only erroneous but illogical.” While acknowledging that complete reliance on a single valuation approach can be appropriate, the court of appeals said it is acceptable only after consideration of the valuation guidance outlined in Rev. Rul. 59-60 and USPAP. Because it relied completely on a single MVIC-Revenue multiple from publicly traded companies, the Tax Court had an obligation to reconcile alternative indicators of value. The Tax Court’s valuation approach, a priori, resulted in an incorrect assumption of the existence and value of Sta-Home’s intangible assets that could not be supported by its financial situation. Clearly, the court of appeals recognized that no buyer or seller would rely on the Tax Court’s valuation for one simple reason: the assets of Sta-Home and their unique characteristics were never considered.

100 See Caracci, 456 F.3d at 454–55.
101 While the Tax Court may not be bound by USPAP, its standards would have been prudent to consider after the court rejected much of the IRS’s expert’s valuation and proceeded to use component pieces to formulate its own valuation framework independent of the testimony and reports of all experts involved in the case.
102 Caracci, 456 F.3d at 460–61.
103 See id. at 461.
E. Lesson 5: The Importance of a Valuation Expert

In the last ten years, the federal courts have significantly revised the admissibility standards for expert witness testimony. Starting with the Supreme Court’s decision in Daubert v. Merrell Dow Pharmaceuticals, the federal courts have shown an increasing intolerance for so-called experts. The Seventh Circuit has clearly demonstrated that Daubert applies to expert business valuation testimony.

In Caracci, the Fifth Circuit emphasized that valuations are not mechanical processes or black boxes; rather, private companies are unique and their valuation is a challenging exercise. While the experts for both the IRS and the Caraccis had substantial valuation experience and appropriate valuation credentials, the IRS’ expert “had no prior experience with the home healthcare industry.” This lack of industry experience resulted in a series of “significant errors in his analysis.” Although it did not invoke the Daubert rule explicitly, the Fifth Circuit voiced skepticism concerning the qualifications of the IRS’s sole expert to render a cogent opinion of value: “[t]he IRS presented an expert who used an inappropriate valuation method and lacked basic factual information essential to the asset valuation he was called on to provide.”

The reversal of the Tax Court’s findings highlights the importance of an appraiser’s actions and qualifications in a transaction involving an exempt entity, especially if the appraiser is later required to provide expert testimony. In an ideal situation, an expert will have a background that includes details from first-hand knowledge of financial and other data specific to recent industry transactions. An ideal expert witness will also have direct experience with a particular guideline transaction and, therefore, have intrinsic knowledge of the circumstances surrounding the transaction and substantive terms resulting in fair market value. Qualifications that include a background in transaction-oriented assignments and relevant industry knowledge differentiate an expert valuation witness from an appraiser who uses “cookie cutter” methods. The Fifth Circuit

105 See, e.g., Target Mkt. Publ’g, Inc. v. ADVO, Inc., 136 F.3d 1139, 1144 (7th Cir. 1998) (upholding exclusion of business appraiser’s report under Daubert due to “analytical gap” between the data and the expert opinion offered).
106 Id.
107 See Caracci, 456 F.3d at 459, 460–61.
108 Id. at 451.
109 Id. at 447.
110 Id. at 462.
recognized the national reputation of the Caraccis’ expert in the home healthcare industry and the significance of the eight weeks he spent on-site with management of Sta-Home “studying the assets and liabilities transferred in the conversion and analyzing the home-healthcare industry in the area.”  

The reversal also signals a continued trend towards a lack of tolerance for inadequately reasoned valuation positions. The IRS and the Tax Court’s methodology were based, in part, upon an expert opinion that “lacked the specific information about the Sta-Home entities necessary to value their assets, particularly the intangible assets.” By reversing the judgment of the Tax Court, the Fifth Circuit clearly reaffirmed the importance of relevant industry and market knowledge in evaluating “the overall cogency of each expert’s analysis.”

VII. A Lasting Legacy?

Beyond providing definitive guidance to appraisers, attorneys, and exempt organizations on the valuation of assets in conversion transactions, the reversal of the Tax Court’s decision in Caracci v. Commissioner contains a potentially controversial position on the fair market value of intangible assets. The Fifth Circuit ruled that Rev. Rul. 59-60 “requires the IRS to assign zero value to unprofitable intangible assets,” and asserted that “unprofitable intangible assets do not contribute to fair market value unless those assets produce net income or earnings.”

In recent conversion transactions, especially those involving Blue Cross/Blue Shield exempt organizations, valuation analyses have emphasized a public market perspective. Certainly, this was the exclusive paradigm used by the Tax Court to determine the fair market value of Sta-Home. Does the Fifth Circuit’s position on unprofitable intangible assets in Caracci v. Commissioner have the potential to impact the market value of an exempt organization?

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111 Id. at 451.
112 Caracci, 456 F.3d at 453.
113 Gross v. Comm’t, 272 F.3d 333, 352 (6th Cir. 2001) (citing Ebben v. Comm’t, 783 F.2d 906, 909 (9th Cir. 1986)).
114 See Caracci, 456 F.3d at 461.
115 See Wellpoint Health Networks Inc./DE, Morgan Stanley Fairness Opinion (Form S-4/A) (May, 18, 1999); Wellpoint Health Networks Inc./DE, UBS Warburg LLC Fairness Opinion (Form S-4) (Dec. 7, 2001); and Wellpoint Health Networks Inc./DE, UBS Warburg LLC. Fairness Opinion (Form S-4) (Aug. 21, 2003).
In the context of a conversion and sale of charitable assets to a nonexempt enterprise, it is unlikely that the position of the Fifth Circuit will have any impact. One of the most complicated and often contentious phases in a conversion process is determining the value of the exempt organization’s assets. The growing number of state and federal regulators, attorneys, accountants, investment bankers, advocacy groups, and local community leaders involved in a conversion transaction often ensures that a proper valuation of an exempt organization’s assets is conducted. In *Caracci*, the lack of willing buyers for Sta-Home was the best indicator of fair market value for its intangible assets. The value of an exempt organization will continue to be determined by market participants.\footnote{After Baptist Hospital in Jackson, Mississippi, acquired Central Mississippi Home Healthcare in October 1994, only three hospitals remained in Sta-Home’s market area that (1) were big enough to enter into a relationship with Sta-Home and (2) did not already have a home health function or relationship. Prior to conversion, Michael Caracci, the CEO of Sta-Home Exempt Agencies, approached each of the three hospitals about the possibility of an acquisition or a joint venture. Simultaneously, numerous publicly traded companies were acquiring private home health agencies. Despite these attempts to find a partner, there was no serious expression of interest to acquire the assets of Sta-Home by either group of “willing buyers.” The Fifth Circuit noted that “Sta-Home discovered that the potential purchasers were uninterested.” \textit{Id.} at 450.}

In circumstances involving other types of business transactions, such as a corporate restructuring, business disposition, or related-party transaction in which the business has an observable pattern of operating deficits, the Fifth Circuit’s position could be controversial. The foundation for the court’s position seems to be a narrow interpretation of Rev. Rul. 59-60 and 68-609 that the valuation of intangible assets be based on a capitalization of earnings in excess of a fair rate of return on net tangible assets.\footnote{Rev. Rul. 68-609, 1968-2 C.B. 327. Similarly, Rev. Rul. 59-60 states: “The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets.” Rev. Rul. 59-60, 1959-1 C.B. 237.}

Without earnings to capitalize there can be no fair market value attributed to a company’s intangible assets.\footnote{The Tax Court specifically found that “[t]he average amount of disallowed costs annually was .7 percent.” \textit{Caracci v. Comm’r}, 118 T.C. 379, 384 (2002). It also found that “[i]t was generally recognized that under the Medicare reimbursement system in place in 1995, there was no ability for home health agencies to realize profits beyond costs . . . .” \textit{Id.}}
Other courts may not find the Fifth Circuit’s reasoning on unprofitable intangible assets compelling or even relevant to future valuation disputes. It is not unusual for a company to have an established history of operating deficits, but have its intangible assets compose a significant portion of a negotiated transaction price. In this instance, however, the existence and value of any intangible assets possessed by Sta-Home was not controlled by the enterprise but by Medicare’s reimbursement system. At conversion, the Medicare cost-based-reimbursement system had created a $1.4 million operating deficit.119 Given Sta-Home’s dependence on Medicare, the Fifth Circuit’s position on the value of unprofitable intangible assets may be viewed by other courts as only having significance within the narrow context

119 Caracci, 456 F.3d at 448.