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3 reasons to use valuation pros in estate planning

Some business owners design their estate plans without consulting a business valuation professional. They use simplified rules of thumb or other do-it-yourself techniques to estimate the value of business interest gifted to family members or donated to charities.

However, this approach can lead to unwelcome surprises down the road. Here's why business owners need a credentialed valuation expert to plan for the future.

1. Rules of thumb may be unreliable

Valuation formulas often are shared at trade shows or in trade journals. They can give owners a feel for their business's worth and serve as a "sanity check" when evaluating the results of other valuation methods. But they're no substitute for a professional valuation.

Start the clock ticking on the statute of limitations by filing a timely gift tax return that includes a qualified appraisal.

Typically, rules of thumb may be expressed as a multiple of gross revenues, earnings before interest, taxes, depreciation and amortization (EBITDA) or some other financial measure. But these simplified formulas are based on averages passed along by word-of-mouth, without regard to specific characteristics — such as management strength, location, debt levels, competition, expected growth and costs — that drive the subject company's value. They're basically folklore that's been collected over time, and they don't usually stand up to IRS or Tax Court scrutiny.

For example, suppose a rule of thumb for a particular industry is three times EBITDA. Using that formula, two industry participants with $500,000 in EBITDA would each be worth $1.5 million. But what if one of the companies isn't investing in R&D, advertising its products or maintaining its assets? These shortcuts may temporarily boost EBITDA, but they're also likely to compromise future earnings and, ultimately, lower its value.

Or what if one business owns its real estate, but the other rents its space? What if one has $1 million of excess working capital on its balance sheet? Blindly applying rules of thumb can also lead to apples-to-oranges comparisons — and erroneous conclusions.

2. Valuation offers peace of mind

When business owners transfer business interests to their loved ones, the IRS generally has three years to challenge the valuation for gift tax purposes. But that period doesn't begin until an owner "adequately discloses" the gift on a timely filed gift tax return.

To satisfy this requirement, the return must provide various details about the transferred interest, the

Limited time offer: Expanded estate tax breaks are only temporary

For 2018 through 2025, the Tax Cuts and Jobs Act doubled the federal gift and estate tax exemption per individual from $5 million to $10 million, with annual indexing for inflation. For 2019, the inflation-indexed exemption is $11.4 million, or effectively $22.8 million for a married couple.

These doubled limits will expire on December 31, 2025. But they may be reduced sooner if Congress needs revenue to fund expenditures.

The higher exemption provides an opportunity to minimize transfer taxes by gifting business interests or other assets to family members before it expires. But some business owners are concerned that a portion of these gifts may be "clawed back" and hit with estate taxes if the exemption is lower when they die.

In 2018, the IRS issued proposed regulations that would avoid clawbacks by providing that the applicable exemption amount is the greater of:

- The exemption amount used to shelter gifts made from 2018 through 2025, or
- The exemption amount that's applicable in the post-2025 year of death.

If the IRS proposal is finalized, a qualified valuation will help maximize the amount of the exemption that's used up before the expanded exemption limit expires.

terms of the transfer and the relationship between transferor and transferee. It must also provide either 1) a detailed description of the method used to value the transferred property, or 2) a qualified appraisal by an independent, qualified appraiser.

Start the clock ticking on the statute of limitations by filing a timely gift tax return that includes a qualified appraisal — even if filing a return isn't required because, for example, the owner hasn't exceeded the lifetime gift tax exemption. A qualified appraiser is one who meets certain minimum education and experience requirements or has earned a designation from a recognized professional appraiser organization.

In addition, the IRS requires business owners who donate more than $10,000 in closely held stock to substantiate charitable deductions with a qualified appraisal by a qualified appraiser. For shares valued at more than $500,000, the appraisal report must be attached to the owner's tax return.

3. A solid valuation lays the foundation for all planning

In general, timely valuations are necessary to make informed business and financial decisions. Otherwise, it's difficult for owners to set a price for their business, forecast retirement income, determine whether their heirs are treated fairly, weigh the potential impact of taxes and explore estate planning options.

Moreover, because value can fluctuate dramatically over time, it's essential to routinely update business valuations. For more information on valuing your business, contact a business valuation expert. ■

Beware of forensic accounting issues when calculating lost profits

Estimating lost profits isn't always cut and dried. It's important to look behind the numbers for signs that they might have been manipulated or falsified.

What might have been

Lost profits calculations are intended to make a business "whole" again — not to provide a windfall from the loss. Put another way, the calculations estimate what the business would have earned "but for" the defendant's alleged wrongdoing or the catastrophic event that interrupted normal business operations.

> *Professional skepticism requires experts to consider whether there's opportunity, motive and pressure to commit fraud.*

Financial experts can help a business calculate not just lost sales, but also the avoided costs because of the lost sales. To determine avoided costs, the business's expenditures generally must be split between:

Direct costs. Examples include raw materials and direct labor, which are directly related to the production of a specific product and almost always vary proportionately with the volume of production.

Indirect costs. These include items such as overhead and indirect labor, which may be fixed or variable. Fixed costs, such as rent, are the same regardless of the level of production (at least within a certain range). Variable costs, such as shipping expenses, depend on production levels.

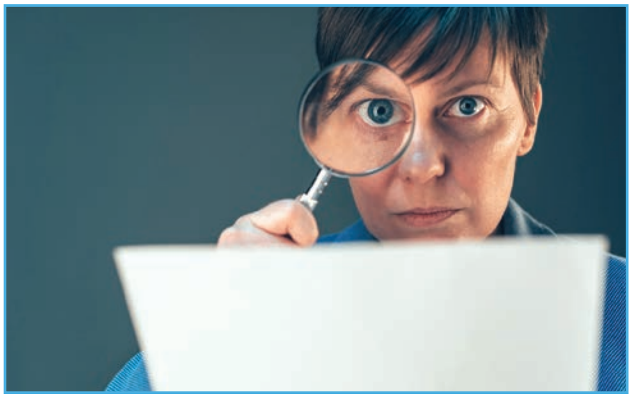
Experts typically subtract from lost sales the incremental cost of producing those sales. The incremental cost generally includes direct costs plus indirect costs that vary with the volume of production, both of which are avoided when sales are lost. But because the business continues to incur fixed costs, despite the lost sales, subtracting those costs distorts its lost profits.

When the numbers don't add up

Experts may turn to a company's income statement or tax returns to help estimate lost sales and avoided costs. But how do you know that historical amounts are accurate? And do historical amounts reflect what's expected to happen in the future? Experts can't just accept management's representations at face value. Instead, they must look at the numbers with professional skepticism.

Consider this hypothetical example: A fire shut down Company A for six months while it rebuilt its headquarters, causing the company to file a claim under its business interruption insurance policy for lost profits and other damages.

The insurance policy defined lost profits as "net profit before taxes, plus continuing normal operating expenses, including payroll." Business interruption policies typically compensate the insured for certain payroll and other continuing expenses to relieve the business owner from the burden and



expense associated with replacing key employees once operations are restored.

In this case, Company A submitted a claim for lost profits that included the continuing salaries of its six regional sales managers. The company also provided copies of payroll tax returns to substantiate the expense. After interviewing the sales managers, however, the forensic accountant who reviewed the claim became suspicious.

Further investigation revealed that the payroll tax returns had never been filed and the taxes hadn't been paid. Inquiries with relevant government agencies also indicated that all six employees were collecting unemployment benefits. As a result of the expert's forensic skepticism, payroll costs were eliminated from the company's lost profits and damages claim.

Why qualitative matters count

Professional skepticism also requires experts to consider whether there's opportunity, motive and pressure to commit fraud. For example, an owner of a struggling business that would be difficult to sell might see an excessive lost profits recovery as his or her way to cash out of the business.

The existence of these elements — known as the "fraud triangle" — doesn't always indicate an inflated estimate of lost profits. But it's important to be aware of the parties' motives and consider their potential effect on the calculation. ■

Telfer v. Telfer

Discount for lack of marketability upheld on appeal

Courts are divided on whether to allow discounts when valuing business interests in shareholder disputes and divorce cases. Whether discounts are equitable typically depends on state law and legal precedent, case facts and, ultimately, the court's discretion.

In a recent divorce case, the Tennessee Court of Appeals upheld a discount for lack of marketability (DLOM) taken on the appreciation in value of two business interests. The *appreciation* in value during the marriage — rather than the value of the family business interests — was included in the marital estate. Here are the details.

Background

The couple was married in 1985. They generally deposited income into and paid expenses from a joint checking account. The wife's father owned RJ Young Company, a supplier and servicer of office equipment. He created the following business entities to transfer wealth to his children:

- Crunk Connected Products (CCP), a partnership that owned the real estate on which RJ Young was situated, and
- Young Leasing, a limited liability company (LLC) that owned no assets when it was created and that operated at a loss until 2005.

By October 1999, the wife owned a 74.8% interest in CCP. In 2000, she began receiving monthly distributions from CCP of $8,500. These distributions were deposited into the couple's joint checking account and used to pay marital expenses.

In 2005, Young Leasing reported its first profit of approximately $619,000. The company retained all of its earnings, however.

The couple had significant tax liabilities from their family business interests. From 1999 through 2006, they received no additional distributions from CCP or Young Leasing to pay the increased tax liability.

The wife filed for divorce in 2010. Contentious litigation ensued, including disputes over the treatment of the wife's business interests and their appreciation in value as either separate or marital property, for purposes of equitably dividing the marital estate.

Eventually, the Tennessee Court of Appeals determined that the *appreciation* in value of the business interests was includable in the marital estate, because "the parties made real and significant contributions to appreciation and preservation of both Young Leasing and CCP." The wife's business valuation expert determined that a 7.7% DLOM should be applied to the appreciation in value of CCP and a 10% DLOM should be applied to the appreciation in value of Young Leasing.

On remand, the husband argued that it was inequitable to discount the value of the business appreciation for its lack of marketability. The wife and her valuation expert disagreed.

To discount or not to discount?

Business valuation professionals apply a DLOM to reflect the lack of liquidity of an ownership interest. Because liquidity refers to how quickly and easily an interest can be converted into cash, a DLOM may be relevant when no ready market exists for an interest or when the provisions in a partnership agreement restrict the ability of a partner to liquidate the interest.

Generally, applicability of a DLOM depends on the characteristics of the ownership interest, not whether the owner of the interest intends to sell it. After considering the facts of this case, the Tennessee Court of Appeals found no abuse of discretion in the trial court's application of "slight" DLOMs to CCP and Young Leasing.

New law

After the final order was issued in *Telfer*, the law in Tennessee was amended to require courts that are divvying up marital assets to consider all relevant evidence in determining the value of an interest in a closely held business or similar asset. This includes valuation methods typically used without regard to whether the sale of the asset is reasonably foreseeable.

The new law effectively overrides any previous case law that suggested that DLOMs shouldn't be applied when valuing businesses in divorce cases unless the business was for sale or a sale was contemplated.

State to state variations

Decisions in divorce and shareholder dispute cases are state specific, and the laws vary significantly from state to state. Before valuing a private business for any purpose, the parties should discuss this issue in the context of relevant legal precedent and the facts of the case. ■

How do nonoperating assets and liabilities affect business value?

When valuing a business, it's important to identify nonoperating assets and liabilities. These nonessential items may have more or less risk than core business operations — and they may have a significant impact on value.

Operating vs. nonoperating assets

Nonoperating assets and liabilities aren't necessary to ongoing business operations. Common examples include:

- Excess cash or working capital,
- Marketable securities,
- Real estate investments,
- Personal property, such as a collection of artwork or luxury vehicles,
- Companies that are unrelated to current business activities, and
- Real estate, equipment or other assets associated with discontinued operations.

Companies with nonoperating assets may incur liabilities associated with these assets. And some nonoperating items generate income or expenses that must be removed from the business's income statement to value ongoing business operations.

Nonoperating items are typically valued separately and then added (or subtracted) to arrive at enterprise value. Valuation methods for nonoperating assets depend on the nature of the assets. For example, real estate would typically require an appraisal, while an investment in another company would likely require a separate business valuation.

Hypothetical example

Val, a business valuation expert, was hired to appraise ABC Manufacturing for M&A purposes. When reviewing the company's balance sheet, Val discovered a nonoperating asset: a parcel of undeveloped land that was recently appraised at $1.5 million. The land generates no income, but it incurs property taxes, insurance and other operating costs. The company also has a $350,000 loan on the property.

To value ABC's manufacturing operations, Val excludes the expenses related to the vacant land from her discounted cash flow analysis. She determines that the value of ABC's core operations is $3.35 million (excluding debt). Then she adds back the value of the land ($1.5 million) and subtracts the outstanding loan balance ($350,000). As a result, the value of the business's equity, including nonoperating assets, is $4.5 million.

This approach provides a reliable picture of ABC's value to a hypothetical buyer, who would have the ability to sell the real estate and eliminate the related expenses. Treatment of nonoperating assets and liabilities may depend in part on the purpose of the valuation, the standard of value (for example, fair market value vs. fair value) and the level of value (for example, controlling vs. minority interest).

Dig deeper

In the hypothetical example, Val didn't just accept the balance sheet at face value. Rather than assuming that all assets and liabilities are part of a business's core operations, it's important to investigate whether the subject company has nonoperating assets and liabilities that distort its potential earnings and value. ■