



The Changing Landscape for Business Valuations

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Estate and Gift Taxes

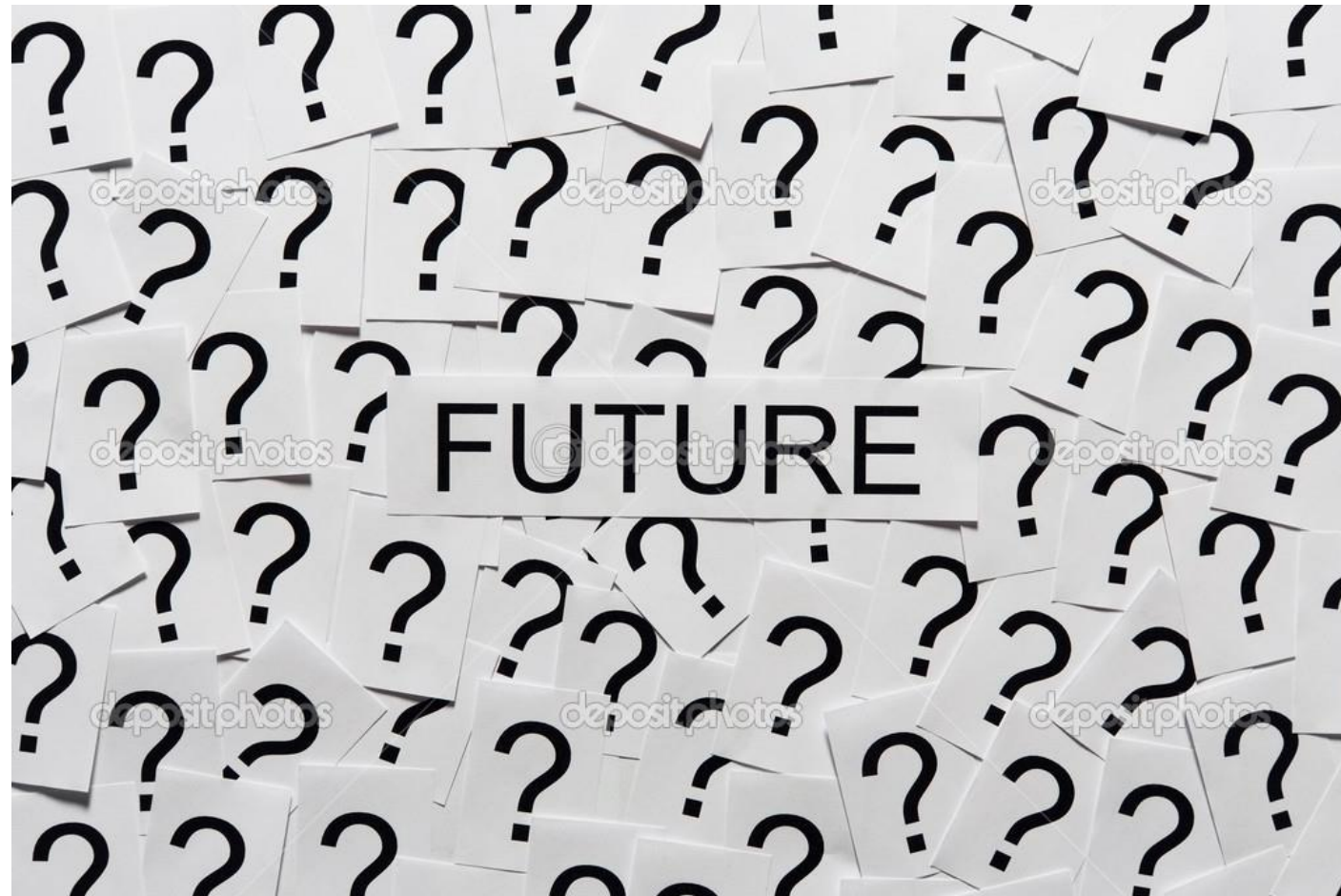


Current Estate and Gift Tax Provisions

- 2017 Lifetime Estate & Gift Tax Exemption is \$5.49M per Person (\$10.98M per Married Couple).
- Exemption Amounts Have Changed Over the Years
\$675,000 in 2001; \$3.5 Million in 2009; \$0** in 2010;
and \$5 Million in 2011.
- In 2010 - Gift and Estate Tax Exemption Amounts Linked
- “DSUE” – Portability Between Surviving Spouses (Usually)
- Federal Estate Tax Rate Increased to 40% in 2013 (No Virginia Estate Tax since July 2007)
- \$14,000 Annual Gift Tax Exclusion in 2016 and 2017 (Was \$10,000 Until 2001).



Current Political Landscape



Congress vs. The Trump Administration



Trump Campaign Proposals



- Complete Repeal of the Estate Tax.
- In place of the Estate Tax – a tax on capital gains held until death valued over \$10 million.
- Unclear whether \$10 million is per individual or couple.
- Unclear about portability between spouses.
- Unclear about carry-over basis or a deemed sale at death.
- Considering disallowing contributions of appreciated assets into private charities established by the Decedent or their relatives.
- No mention about repealing the GST Tax and Gift Tax.
- If Gift Tax – what about lifetime exemptions & exclusions?

Trump Tax Proposals – Updated April 26, 2017

- Only comment regarding Estate Taxes in the Release was to “Repeal the Death Tax.”
- The 4/26/2017 Release did **NOT** address:
 - Gift Taxes or Generation-Skipping Transfer Tax (“GST”).
 - Basis of Assets (at death or for gifts).
 - Limitations on contributions of appreciated assets to private charities (which has been previously discussed).
- The 4/26/2017 Release “Goals for Tax Reform”:
 - Grow the economy and create millions of jobs.
 - Simplify our burdensome tax code.
 - Provide tax relief to American families (especially middle income families).
 - Lower the business tax rate from one of the highest in the world to one of the lowest.

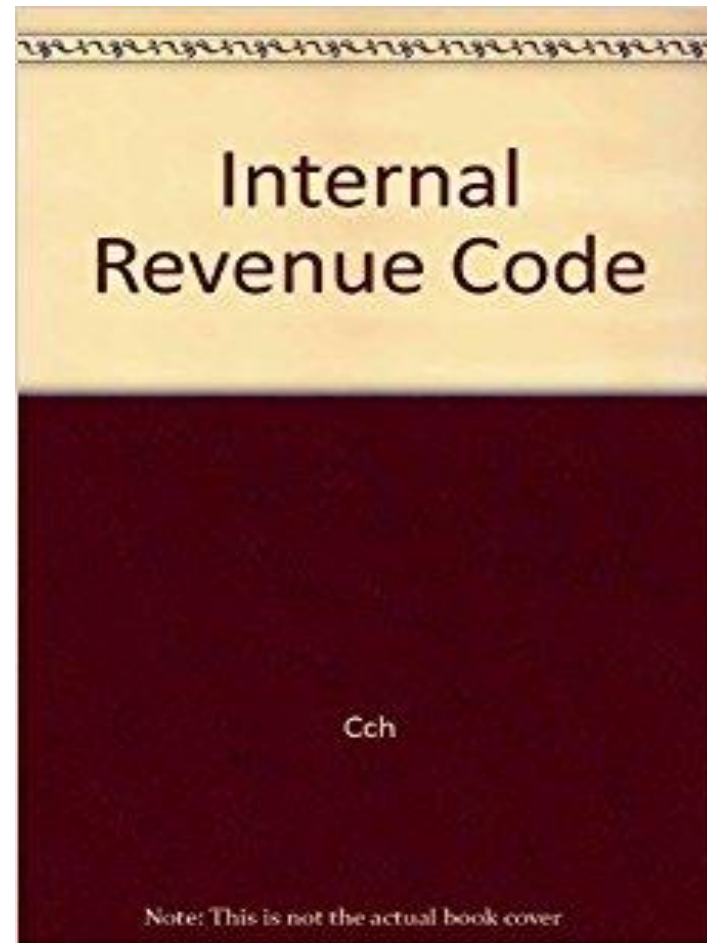


Planning Implications



- Estate Tax may not be changed.
- The change may be phased out over a number of years.
- A repeal may be repealed by the next Administration.
- Trump and GOP must decide how to allocation “political capital” to the most important priorities.
- Some tax reform measures will particularly benefit wealthy individuals – so difficult for some in Congress to agree.
- Reform may not pass due to the limited “political capital” in getting other more important tax reform measures passed.
- If Estate Tax is repealed, all existing planning and documents, including wills and revocable trusts, should be reviewed.

Proposed Regulations §2704



Summary of Proposed Regulations §2704

- In light of a perceived avoidance and ineffectiveness of certain provisions in §2704, the IRS has proposed a number of new regulations including:
 - Change the definition of a “**Controlled Entity**” to be viewed through the lens of an entire family including lineal descendants as opposed to individual(s).
 - Amend the regulations to address what constitutes control of an LLC or other entity that is not a corporation, partnership, or limited partnership.
 - Create a new definition of value – referred to as “**Minimum Value**” (which is really “maximum value”).
 - Ignore transfer restrictions for minority interests and thus assume that they would be marketable, regardless of governing documents and/or state laws (referred to as “**Disregarded Restrictions**”).
 - Amend the regulations to limit the use of eliminating or lapsing rights (voting or liquidation rights) and limit the exception to transfers occurring three (3) years or more before death.
 - Ignore the presence of non-family members with less than 10% of the overall equity value

2017 Updates on Proposed Regulations §2704

- Important Points from IRS's Catherine Hughes:
 - No intent to eliminate all minority discounts.
 - No intent to create a "deemed put right."
 - No intent to make the 3-year lookback rule retroactive.
 - Regulations do not distinguish between operating and non-operating businesses (which is a big issue to everyone).
 - Looking for a workable distinction between operating and non-operating businesses to address this issue.
 - Regulations do not distinguish between functional and dysfunctional families (which is another sticking point to families and their advisors).
 - Do not expect a resolution to these issues any time soon.

Takeaways for Proposed IRC §2704

- Talk with your clients and referral partners about prudent planning during 2017.
- Discussions about transferring ownership interests – but only for good business, non-business, family and estate planning reasons (i.e. Don't Panic!).
- Everything in taxation could change over the next year or so under the President Trump and Congress.
- We have entered uncharted territory – stay informed and stay tuned.
- Be ready to advise clients to move forward with sound ownership transfer strategies – if and when warranted.
- There are still plenty of non-tax reasons for prudent estate and gift tax planning.

Business Valuations

Why People Want Business Valuations



Valuation and Calculation *Engagements & Reports*

Professional Organizations (NACVA, AICPA, ASA, IBA, etc.)
Attempt to Provide Standards, Rules & Guidance for Members

Conclusion of Value

- Detailed Report
- Summary Report

Other Reports

(Litigation Support)

- One Page Summary

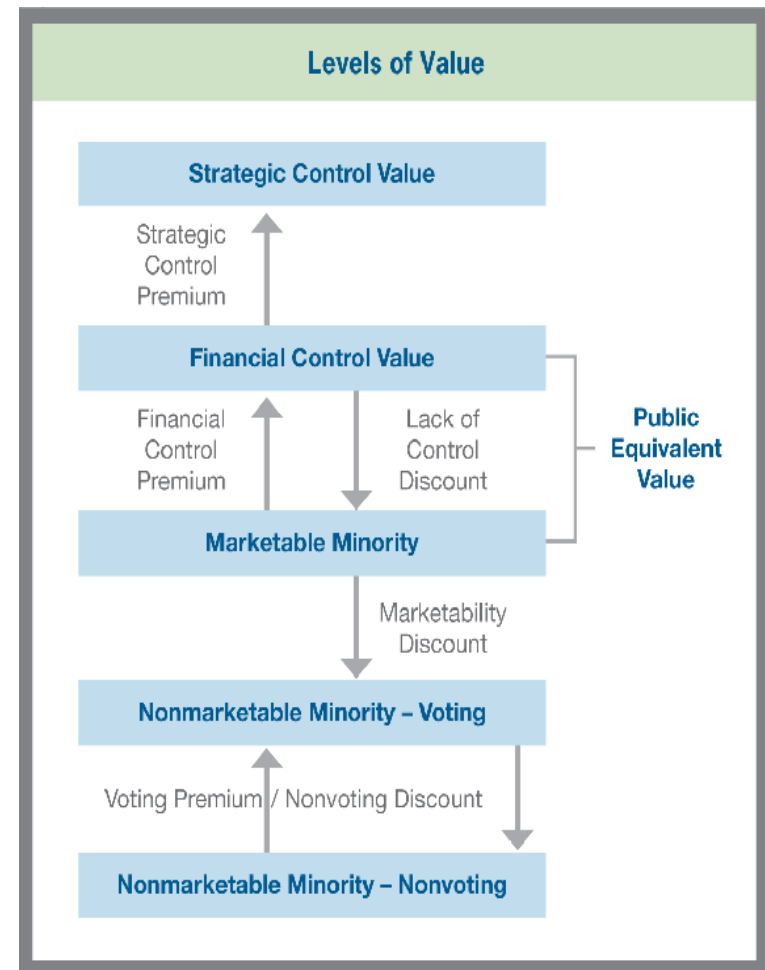
Calculation Engagement

- Calculated Value
- Calculation Report

*Matching Valuation Reporting
with Requirements with Client
Needs and Cost Factors*

Levels of Value in Valuations

- Strategic Control
- Financial Control (MV)
- Marketable Minority
- Nonmarketable Minority
 - *Voting*
- Nonmarketable Minority
 - *Nonvoting*

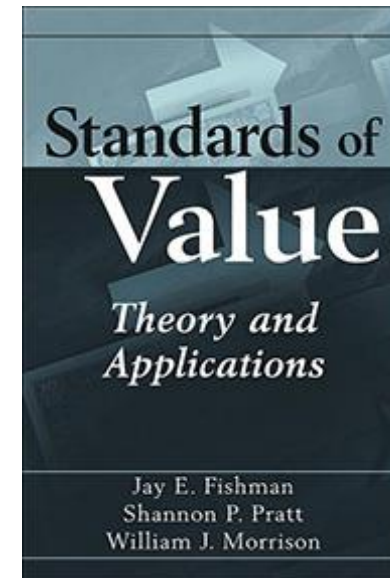


Standards of Value

- There are many types of “value.”
- Each one means different things to different people and may (or sometimes *must*) be used for different circumstances.
- Business valuations = economic value.

Fair Market Value (FMV)

- Investment Value
- Intrinsic Value
- Fair Value
- Book Value
- Liquidation Value
- Premise of Value:
5 Generally Accepted Premises of Value:
 - Value as a going concern
 - Value as an assemblage of assets
 - Value as an orderly disposition
 - Value as a forced liquidation
 - Value as defined in a contractual agreement (e.g. - Buy/Sell)



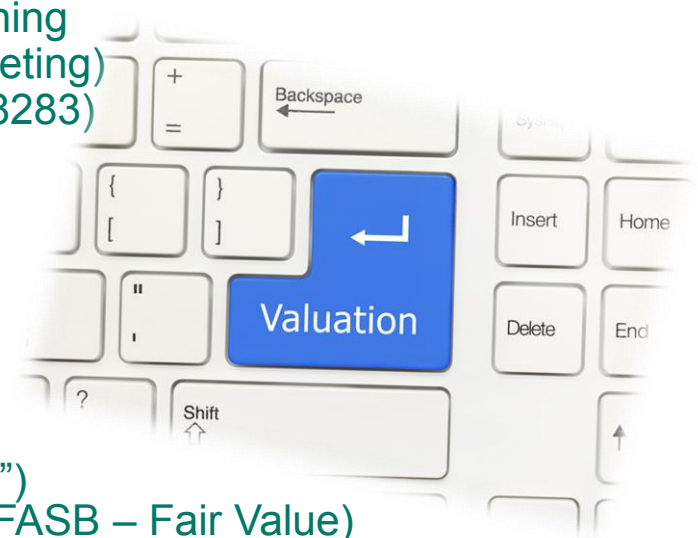
Reasons to Value Businesses

Tax Valuations

- Estate Tax
- Gift Tax (Important - IRS “Adequate Disclosure Requirements”)
- Allocation of Lump-Sum Purchase Price (Goodwill)
- ESOPs (See Michael Coffey’s Succession Planning Presentation from February 2017’s CVEBC’ Meeting)
- Charitable Donations (Qualified Appraisal Form 8283)

Non-Tax Valuations

- Purchase & Sale of Businesses
- Mergers
- Buy/Sell Agreements
- Goodwill Allocation (Personal and Enterprise)
- Divorce
- Litigation Support
- Shareholder Dispute (State Statute – “Fair Value”)
- Financial Statements and Goodwill Impairment (FASB – Fair Value)
- Economic Damages and Lost Profits
- Patents and Trademarks (Relief from Royalty)
- Intangible Value of Workforce Employees
- Specific Asset Value: Tangible (A/R, Limited Scope) or Intangible (Goodwill, Workforce, Leases, etc.)
- Other Purposes



Indicators of Value

Value Drivers



Higher Values

- Organized Business
- Segmented Client Database
- Defined Services and Pricing
- Client Reporting and Management
- Income and Expense Controls
- Ability to Generate New Fees
- Consistent Cash Flows
- Well Documented Client Agreements
- No Problem Transferring Clients

Lower Values

- Less Organized Business
- Client Database
- Largely Commission Revenues (Few Fee Based Revenues)
- No Client Agreements
- Informal Processes
- Client Service Level
- No Management Information Systems
- Quality of Support Staff (If Lacking or Inexperienced)
- Difficulty Transferring Clients

Normalizing Financials

Normalizing Adjustments

Balance Sheet

- Accounts Receivable
- Inventory
- Marketable Securities
- Fixed Assets
- One-Time Gains/Losses
- Liabilities
- Other Unusual or Non-Recurring Adjustments

Income Statement

- Officer/Owner Compensation
- Discretionary Expenses
- Related Party Expenses
- Lease Expenses
- Non-Operating Income and Expense Items
- Non-Recurring Income and Expense Items



Valuation Discounts and Premiums

- Discount for Lack of Control
- Discount for Lack of Marketability
- Illiquidity Discount
- Other Discounts
- Premium for Control
- Synergistic Premium
- Other Premiums



Discount for Lack of Control

AKA – Minority Interest Discount

Level of Control of Minority Interest

Non-Controlling Interest < Complete or Majority



Control Features

Common Prerogatives of Control:

The value of control depends on the owner's ability to exercise any or all of a variety of rights typically associated with control.

Common prerogatives of control include:

- Electing directors and appointing management
- Determining management compensation and perquisites
- Setting policy and changing the course of business
- Acquiring or liquidating assets
- Selecting people with whom to do business and award contracts
- Making acquisitions of other companies
- Liquidating, dissolving, selling out, or recapitalizing the entity
- Selling or acquiring treasury shares
- Registering the entity for public offering
- Declaring and paying dividends
- Changing the entity's owner agreement
- Blocking any of the above actions



Discount for Lack of Marketability

AKA – Marketability Discount and Illiquidity Discount

Liquidity of Interest

- How Quickly
- How Certain
- Minimize Loss

Marketability of Interest

- Appropriate Market
- Prepare for Sale
- Execute Sale
- Transaction Costs

Factors

- Type
- Size
- Diversification of Assets
- Cash Flow
- Dividends
- Liquidation Time
- Ownership Restriction

Other possible Valuation Discounts/ Adjustments include:

- Key Person Discount
- Volatility Index Discount (“Fear Factor”)
- Blockage/Swing Vote Discount
- Built-In Gain (or Embedded Gain) Discount
- Personal Goodwill Adjustment
- Non-Homogeneous Property Adjustment
- Litigious Owner Adjustment
- Assignee Discount
- For Real Estate – Undivided Interest Adjustment
- Environmental Adjustment
- Tiered Discounts (Underlying Assets/Investment)

Opportunities and Pitfalls in Shareholder Buyout Provisions



Business Valuations in Shareholder Buyouts

- Critical factor is the Company's governing documents.
- Do the documents provide for an orderly buyout?
- Do the documents provide for the definition of "value"?
- Pitfalls of not defining "Value" or who determines the Value.
- Advantages/Disadvantages of FMV versus Fair Value.
- Who pays for the business valuation?
- Will there be more than one valuation (one by the Company and one by the departing shareholder)?
- Is there a "tiebreaker" valuation – and who pays for it?
- Group discussion on Shareholder Buyout scenarios:
 - Fair Market Value
 - Fair Value

Group Discussion on Experiences in Shareholder Buyout Situations

- What were the buyout provisions?
- Was “Value” defined?
- Who determined the “Value”?
- Was a business valuator involved?
- Was there a “tiebreaker” provision?
- How did it resolve?

Business Valuations in Succession Planning

- Often, the decision is whether to sell a closely-held family business – or to transfer ownership to a family member(s).
- Does the senior generation want their children or others to get equal amounts of benefits from their estate?
- The value of the business is a cornerstone of succession planning – need to have a baseline
- The independent business valuation allows the owner to decide how to allocate assets.
- Do they gift or sell ownership interests to family members, to Trusts, to key employees, etc.?
- Need for buy/sell agreements, life insurance funding, etc.
- Group discussion on succession planning scenarios.

Business Succession Planning Tips

- Pick a Successor
- Develop a Formal Training Plan
- Establish a Timetable
- Establish the Value of the Business
- Establish a Buy-Sell Agreement
- Estate, Gift and Income Tax Planning
- Install the Successor
- Consult – or Retire?



Best Practices - Group Planning Discussion: How Are You Helping Clients Plan Today?



Business Valuation Case Studies

- Standards of Value (FMV, Fair Value, Book Value, etc.)
- No Valuation Discounts
- Limited Valuation Discounts
- Limitations on Ownership
- Limitations on Property Usage
- Other Situations



Role of Business Valuations in Business Succession Planning

- Planning
- Implementing
- Retrospective



Appendix

More on Proposed IRC §2704



What is Value?



- **Fair Market Value** is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”
- New definition of value proposed under IRC §2704 is referred to as **Minimum Value** and this is defined as “the pro rata share of the net fair market value of the assets of the entity - that is, the fair market value of those assets reduced by “certain” debts of the entity.

IRC §2704 – “Disregarded Restrictions”

- “**Disregarded Restrictions**” in IRC §2704 are certain “Applicable Restrictions” that might otherwise reduce the valuation of a family business. These restrictions are ignored if the transferor or his/her family have the right to remove the restriction after the transfer (and if the restriction is more restrictive than what State law already provides).
- Examples of “Disregarded Restrictions” proposed in §2704:
 - Limits the ability of the holder of the interest to liquidate the interest;
 - Defers the payment of the liquidation proceeds for more than six months;
 - Permits the payment of the liquidation proceeds in any manner other than in cash or other property (other than certain notes); or
 - Limits the liquidation proceeds to an amount that is less than a “Minimum Value.”

IRC §2704 – “Safe-Harbor” Exceptions

There is a potential “Safe-Harbor” exception that would allow the valuation discounts to be applied, which involve the presence of a nonfamily owner in the business:

- The nonfamily owner must own at least a 10% interest,
- The nonfamily ownership block needs to be at least 20%,
- The ownership needs to be held for at least three years,
- Ownership must be given a “put” right allowing the nonfamily member to request payment for the shares at any time and they must be paid within six months, and
- Ownership must be paid “minimum value,” which is essentially pro-rata value of the business as a whole.

Obviously, qualifying for this Safe-Harbor would be very difficult in most family business situations.

IRC §2704 Defines “Family Members”

Section 25.2702-2 of the proposed regulations defines “Member of the Family” for control purposes to include:

- A. An individual’s spouse
- B. Any ancestor or lineal descendent of an individual or individual’s spouse
- C. Any brother or sister of the individual
- D. Any spouse of any individual described in subparagraph (B) or (C).

Thus, depending upon the overall ownership of a family business, a “Nonfamily Member” could be a “Collateral Relative” such as an aunt, uncle, cousin, nephew, or niece.

§2704 Proposed 3-Year Lookback To Determine Lack Of Control Discounts:

- Under the new Treasury Regulation 25.2704-1(c)(1), any lapse of a restriction or liquidation right within 3 years of death is treated as a lapse at death (which in turn would be re-included in the decedent's estate).
- In essence, this provision means that changes in ownership intended to trigger a minority discount on shares held at death may no longer produce such a discount.
- It is unknown at this time how the 3-Year Lookback would apply to transfers made in 2016 or 2017.

Summary Points for Proposed IRC §2704

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Summary & Closing



Questions, Comments & Contact Info



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