

VALUATION OF A CLOSELY HELD BUSINESS

Why determine the current value of a business? Because if a major shareholder or partner dies, and you have not determined a value, the Internal Revenue Service, will do it for you. The IRS will select the method(s) of valuation as provided for in its regulations to create the highest value possible for tax purposes. This situation is rarely advantageous for the taxpayer.

A value must be placed on a business in any of the following instances:

- Preparing a buy-sell agreement
- Contemplating the sale or purchase of a business
- Handling a gift of stock or partnership interest
- Death or disability of a shareholder or partner
- Transferring stock to an Employee Stock Ownership Trust

Two major valuation considerations are market value and intrinsic value factors. Intrinsic value factors are broken down into the following two categories: earnings capacity and other considerations.

MARKET VALUATION

This is the preferred method. The greater the market activity in a company's stock, the more weight can be placed on this method. This method is not applicable, however, to partnerships or corporations where there has been no trading activity. Even with traded companies, there can be serious limitations with this method, including:

- Lack of stock transactions near the valuation date
- Chance of a manipulated market. This is one controlled by major shareholders for their own benefit
- Effect of a boom or depression on the market price
- Inability to obtain control. This usually occurs due to the unavailability of sufficient stock in the marketplace

If the stock is traded over-the-counter or through an exchange, these prices will prevail. The only exception is if the amount of stock, added to the purchaser's other holdings, will constitute a controlling interest. That would increase the value of the shares. If both bid and ask prices are available, the mean price is used.

The recent sale of a similar business in a similar market can often be a good guide as to value, but it requires a substantial knowledge of the similarities between the two businesses.

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INTRINSIC VALUATION

If the fair market value cannot be determined by reference to market transactions or to values set by arm's length agreements, (buy-sell agreements, etc.) then intrinsic factors must be taken into account. The main categories under intrinsic value factors are earnings capacity, current financial statements and other considerations.

EARNINGS-CAPACITY INTRINSIC VALUE

Stock market analysts use price earnings ratios as one of their major indicators. A buyer is particularly concerned with the future earning power of the company. The past earning power is considered to estimate future earning power under these rules:

1. Five or more prior year's earnings should be taken into account to predict earnings.
2. Earning trends (the progressive increase or decrease in net income) should be given more weight than the average earnings for a five-year period.
3. If previous year's show a loss (and it is not a manipulated loss), the loss should be computed into the average.
4. Determination of earnings in both the year in which the valuation date occurs and later years is appropriate.
5. Abnormal economic periods should be considered.
6. Abnormal or non-recurring factors such as change in accounting methods, unusual capital gains or losses, or heavy retirement plan contributions must be weighted.
7. The salaries, employee benefits and other perquisites of shareholder officers and their effect on earnings must be weighted.
8. The loss of a key person can have a dramatic effect on future earnings.

Once the average earning power is computed, the proper multiplier to capitalize that power must be determined and applied. The multiplier is directly proportional to the risk factor. The greater the risk, the smaller the multiplier. The best guide in determining a multiplier is to note comparable multipliers of publicly traded companies. If this is not possible, you might use comparable non-publicly traded companies.

After comparable companies have been located, the average price-earnings multiplier of their shares can be applied to the earnings of the stock to produce a valuation.

OTHER CONSIDERATIONS - INTRINSIC VALUE

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- Dividend-paying capacity rather than previous actual paid dividends are another primary consideration of the IRS. This is quite close to an earnings factor
- Book value or book value-net asset factor can only be considered after it is determined that the asset values on the books are close to their fair market value
- Lack of marketability can arise with either a minority or a majority interest. Too large a block or too small a block can result in a limited ability to sell. Legal or contractual restrictions on sale may also contribute to a lack of marketability. There is no general rule on how large a marketability discount will apply to a stock value

In order to place the burden of proof concerning the actual value of a business in the hands of the owner, the IRS has intentionally left the regulations vague. According to the IRS, the following relevant factors will affect arrival at a fair market value:

1. The nature and history of the business.
2. The conditions and outlook for the specific industry and the general economic outlook.
3. The financial condition and book value of the business.
4. The earnings and dividend paying capacity of the corporation.
5. Previous sales of stock and the size of the block to be valued stock as compared to the total outstanding stock.
6. Comparison of stock prices of corporations in the same or similar lines of business being actively traded in a free and open market, either on an organized exchange or over-the-counter.
7. The existence of goodwill or the presence of other intangible value.

CONCLUSION:

There is no fail safe way to value a company for buying and selling purposes. However, there are a number of good approaches to estimate value; some of those discussed above. Every business is unique and the valuation approach must also be matched to the subject company.

It is not unusual for a buyer – or the tax authorities – to ask for the logic behind a market valuation. Having a credible answer to that question will enhance your chances that the value will be accepted.

But by far the best valuation is a binding, funded (fully or in substantial part) Buy-Sell Agreement. Governments nearly always will accept this, unless the agreement has not been reached on an arm's length basis. For example, sometimes a father would agree to a Buy-Sell Agreement at a very low price with a family member for a partial interest in the business – in an attempt to have the entire business valued on that basis. A Good Buy-Sell arrangement should include reference to how the values were derived. Resource: TLS

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