A STRATEGY SPOTLIGHT

# Determining Fair Market Value of Businesses — General Rules

## Overview

Determining business valuation is not an easy process, and it is recommended that it be done by a professional appraiser. There are a variety of methods and factors to consider when determining business valuation. For most businesses, a simple formula of assets minus liabilities (a book value formula) is not a complete assessment of value.

Other important factors to consider include:

- Average annual earnings;
- Number of years a business has been in existence;
- Nature of the business;
- Ownership control;
- Goodwill or the earning power of a business in excess of a fair return on the business' tangible assets; and
- Price earnings multiples of comparable public companies.

Once the initial business valuation has been done, it should be adjusted or updated as needed to reflect any significant change in business operation or value.

### KEY POINTS

- The fair market value of a business affects business and estate planning.
- There are factors that affect fair market value.
- There are possible consequences for getting it wrong.

## Estate Tax and Business Valuation

The value of a business interest, like any other property included in a decedent's estate, is assessed at fair market value (FMV) for estate tax purposes. The tax law provides that this is the hypothetical price that a willing buyer would pay and that a willing seller would accept when neither is under any compulsion to buy or sell and both have reasonable knowledge of the relevant facts.

An advantage of a buy-sell agreement is the ability to set or predetermine the estate tax value of a business interest and to not leave an estate open to the long, expensive and often losing process of trying to prove a lower value against a higher assessment by the IRS. In general, unrelated parties can achieve this with a buy-sell agreement.

The value may be based on an accepted valuation formula or model such as a percentage of gross sales plus inventory and other items that are normally used in that particular business community. Alternatively, it may be necessary to base the value on the judgment of a professional appraiser. However, failure to make sure the business is properly valued may lead to the assessment of unexpected taxes and perhaps penalties.

This assumes that each party is acting in their own best interests. However, if the parties are related or are involved in a personal relationship (other than involving their business dealings), there may be a presumption by the IRS that the parties intentionally undervalued or overvalued the business interest. Additional rules may apply to determining fair market value when related parties are involved.

## The Bottom Line

Knowing the value of a business interest is an important part of business and estate planning. Many factors need to be considered when determining the value, including the nature of the business, earnings history, and the value of comparable companies. Working with a professional and using a standard valuation process may help avoid unwanted consequences to both the business exit strategy and the estate.

MassMutual does not provide qualified business valuations. For a qualified or certified business valuation, consult a properly credentialed appraiser.

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