The Critical Nature of a Business Valuation in Estate Planning

by Chris Hamilton, CPA, CFE, CVA, DABFA

Many business owners fail to recognize the importance of obtaining a valuation for estate planning purposes. In the event of death of the owner, such a failure to have an appropriate valuation completed can actually result in the forced sale of the business or other key family assets. However, this dire situation is not necessary. Let us consider a typical situation that may apply to many business owners.

Typical Scenario: The Duncan Family

The Duncan family is typical in several respects. Jim and Liz have worked almost a lifetime together to build a business, a family, and a comfortable life. They have achieved all of it as represented by their 4 children and 11 grandchildren (so far) along with a successful business, a beautiful home, and a very comfortable retirement. Jim is still active in what he calls "the family business." He continues to work for several reasons – he loves it and he feels that he needs to protect his investment. He has also determined that he is not comfortable handing the business over to his management team. None of his children have shown any interest in working in the business either now or in the future. The business has grown to be quite successful and it provides the cash flow that supports the comfortable life for the Duncans. There have been several offers to buy the Duncan's business over the years but Jim has never really considered them because he has always wanted to keep the family-owned business in the family for the sake of his children and his grandchildren.

This scenario presents two very common and significant dilemmas that require business valuation expertise:

- The estate of Jim & Liz probably has significant value which will result in estate taxes.
- A succession plan is needed to assure the continuity of the business after Jim is gone.

In this article we will address the estate and gift planning aspects. Next month we will address succession planning.

The Critical First Step

Mr. Duncan has several options facing him as it relates to the estate and to gift planning. Of the several options, none could be recommended as better than any other until the value of the business is known. Generally, estate taxes are assessed on the Fair Market Value of net assets of the estate upon the death of the second spouse. In the case of the Duncans, they do not know when the second spouse will die or which spouse that will be, as well as what the taxes will be – because they do not know the value of the most significant asset. There is the added uncertainty of no clear answers on the estate tax rate or estate value that will be taxed. Of all that uncertainty, the easiest to resolve is establishing the value of the estate.

The glaring concern in the scenario presented above is the ability of the Duncan family to pay the estate taxes when they are due. If history is any proxy for the future, the estate tax will likely be in the neighborhood of 50% if the net asset value that exceeds some dollar value (e.g., $3,000,000). That means that if the value of the home, retirement and investment assets, and the business equals $5,000,000 the estate tax that will be due will approximate $1,000,000. The Duncan estate is valuable – but not liquid. After the death of a parent, it is a terrible discovery by the living beneficiaries that assets must be sold to finance the taxes.

In the scenario above, it is an imperative first step to value the estate. This means appraising the real estate (market comps are probably sufficient) and valuing the business. Valuing the estate is a

prerequisite for assessing the estate tax "problem" and developing a plan to finance and/or mitigate estate taxes.

What Type of Valuation Is Necessary?
If done incorrectly, retaining a valuation expert can be an expensive and wasteful exercise. There are many valuation firms that will charge in excess of $15,000 to appraise a business. This is a necessary expense if the IRS or a court is requiring a full-disclosure appraisal. Outside of those requirements, a business owner does not need to spend that much. A business appraiser should be hired as a consultant to come into the business and determine a "ballpark" range that the business is worth – on a "fair market value" basis. The FMV standard of value is a specific method dictated by the IRS tax code for purposes of determining estate and gift taxes. To obtain a value on any other standard of value is not relevant for purposes of planning for taxes. For example, some business owners do their estate planning based on offers they have received for the purchase of the business. These offers may not have been consistent with how the IRS defines fair market value.

A "ballpark" range of values is the equivalent to a market comp valuation of the personal residence. It is not precise but it is close enough to allow the Duncans to proceed with a comprehensive estate and gifting plan.

Contact a Valuation Professional
In the case of the Duncans, as with many business owners with significant business and personal assets, estate planning is quite incomplete without an appropriate valuation. Contact the valuation experts at Arxis Financial, Inc. to learn more about what is needed for your particular situation.

<u>About the author:</u>
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