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Practical Applications of Business Valuations for Estate Planning Purposes

by Chris Hamilton, CPA, CFE, CVA

Most business owners pay close attention to the taxes that are assessed on gross revenue, taxable income, and payroll. A more significant tax is lurking as the profitability and stability of the closely-held business is established. Over time this tax liability may become so significant as to alter the ability of the business owner to transfer the business to the "next generation." This tax is the estate tax. And, unlike most other taxes that are assessed on the economic results of operations, the estate tax is based on the value of the company as a whole.

Estate taxes are due in a relatively short period of time. Most small businesses are "for sale" for more than a year. Yet, estate taxes are due in a matter of months from the date of death of the business owner. To the extent the business is the most significant, or only, asset in the estate, liquidating that asset to pay the taxes can cause a huge economic loss through a "fire sale" of an asset that otherwise would sell for much more.

Unintended Consequences

Another significant issue in estate planning is the attempt by most to "equalize" the estate among children. Consider this example: An estate consists of a business, a personal residence, marketable securities and cash. There are three children and the estate documents state that one sibling is to get the business, another the home, and the rest of the estate to the third sibling with a cash payment made to equalize the estate value. It sounds simple – the estate is split equally among the three children. This is a very common scenario. It may make a lot of sense when the planning documents are established.

However, the practical result is often quite complex and problematic. One possibility is that the cash and marketable securities are depleted by professional fees and taxes. That leaves two siblings with valuable but illiquid assets. Another possibility is that the sibling with the business has the asset that is substantially more valuable than any of the other assets but is the least marketable. Since there is insufficient cash in the estate and/or the business, the only practical solution is to split up the ownership of the business to equalize the estate. This raises considerations of management control and profit allocation among the siblings. Valuing the partial interests becomes a difficult and cumbersome process.

Five Key Steps

The above illustrates some of the complexities involved in owning a small business at the time of death. The challenge is not just estate taxes but also succession of ownership in such a way that the business is not disrupted. The following are five key steps to consider when preparing a comprehensive estate plan involving a closely-held business.

1. **Know what the estate is worth.** The starting point is to determine the value of the assets in the estate. This is a critical step in the planning process to accommodate estate taxes as well as the division of the estate according to specific wishes. Where a business interest is involved, a business valuation expert will be needed to provide either a value or a range of values. The valuation expert should also provide the owner with an understanding of how the value is determined so that as the business grows or contracts the owner has a good sense of how the business will be valued. If that is understood, the business owner will have a better idea in the future whether the plan needs to be adjusted.

2. **Know how much estate tax may be due.** Federal law determines the calculation and amount of estate taxes. The business valuation expert should be experienced in valuation for estate and gift taxes. The standard of value is specific and important to know. Estate taxes are paid on the Fair

Market Value of a business – not liquidation, book, or fair value. These may sound like innocuous or semantic issues but they actually can result in enormous surprises if not planned.

3. **Plan to avoid estate taxes if possible.** An estate attorney along with a business appraiser can assist the owner is minimizing the estate taxes assessed on an estate. One of the strategies is to begin gifting interests in the business to beneficiaries during life. This also has the dual benefit of beginning to shift the management control of the business. To effectively plan and implement strategies to reduce estate taxes requires the use of a valuation expert who has experience in valuing non-control non-marketable interests in a closely held business.

4. **Plan to fund the estate properly.** As has already been demonstrated, a cash-poor estate causes problems for the beneficiaries that were likely unintended. The consequences include distressed sale of assets, conflict among the beneficiaries, money wasted on lawyers and accountants, and sometimes litigation. Estate planning is more effective when the true asset values are considered rather than an "estimate" by the business owner. Life insurance is one consideration for funding post-death taxes, expenses, and equalization. Another possibility is transferring some or all of the business during life and establishing a shareholder's agreement to address post-death liquidity. None of this resolves the flaw in many plans – not having a valuation of the business completed during the planning process.

5. **Use professionals effectively.** Any estate plan should be reviewed with family and other trusted advisors. In that mix should be an estate lawyer and a business appraiser. The business appraiser should be able to provide a range of value for the business without the investment of a full-blown appraisal report. The result of a valuation engagement should be a better idea of how the subject business is valued and how the estate could be divided equitably while avoiding as much estate tax as possible. Life insurance planning is more effective with a reliable valuation of what may be the most significant asset – the business.

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