Business Valuation

Why Understanding Business Worth is Key to Effective Planning

By: Sean Parrish, CVA, MAFF, CVGA

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DETERMINE AND GROW YOUR BUSINESS VALUE

Purpose of Presentation

- Understand the role business valuation plays in estate planning
- Help clients transfer and ensure equitable distributions of wealth
- Help facilitate smooth transitions for heirs and successors

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Agenda

- What is business valuation?
- Foundation of Business Valuation (Gift & Estate)
- Methods of Valuation
- Discount Rates
- Importance of Business Valuation in Estate Planning
- Case Study
- Q&A

What is business valuation?

Definition: Estimating the economic value of a business or ownership interest

Key Objectives in Estate Planning

- Determining value for tax purposes
- Planning for wealth transfer
- Resolving family ownership transitions

The Foundation of Business Valuation

Estate Valuation (C.F.R. § 20.2031-1):

- Addresses the broader valuation of all estate assets at the time of death.

Gift Valuation (C.F.R. § 25.2512-1):

- Focuses specifically on gifts and the valuation at the time of transfer.

Closely Held Business Valuation (Rev. Rul. 59-60):

- Offers an in-depth methodology tailored to the complexities of valuing non-publicly traded businesses, relevant in both estate and gift tax contexts.

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The Foundation of Business Valuation

IRS Revenue Ruling 59-60:

- **Purpose**: Offers detailed guidance on valuing closely held business interests for **estate and gift tax** purposes.
- **Focus**: Specifically addresses the unique challenges of valuing closely held corporations, emphasizing financial metrics, industry conditions, and other qualitative factors.
- **Standard**: Expands on the fair market value standard with a structured methodology for closely held business interests. (hypothetical buyer hypothetical seller at exchange arm's length.)

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IRS Revenue Ruling 59-60:

Highly detailed and focused on closely held corporations, providing an 8-factor framework for valuation:

1. **Nature and history of the business**
2. **Economic outlook of the industry**
3. **Book value of the stock**
4. **Earnings capacity**
5. **Dividend-paying capacity**
6. **Goodwill or intangible value**
7. **Stock sales and size of the block**
8. **Market conditions**

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1. Nature and History of the Business

Description: This includes the type of business, its products or services, organizational structure, and operating history.

- **Key Considerations**:
  - Longevity and stability of the business.
  - Milestones achieved (e.g., expansion, acquisitions, or innovations).
  - Past challenges and how they were managed (e.g., market downturns or legal disputes).

Why It Matters: A company with a long, stable history often has a higher valuation than a startup or a business with inconsistent performance.

2. Economic Outlook of the Industry

Description: Evaluates the current and future health of the industry in which the business operates.

- **Key Considerations**:
  - Industry growth rates and trends.
  - Technological advancements affecting the sector.
  - Regulatory environment and competitive landscape.

Why It Matters: A favorable industry outlook can enhance a business's value, while a declining or overly competitive market might reduce it.

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3. Book Value of the Stock

Description: The net value of the company's assets as recorded on its balance sheet (total assets minus liabilities).

- **Key Considerations**:
  - Adjustments for asset obsolescence or overstatement of values.
  - Inclusion of intangible assets not typically reflected on the balance sheet.

Why It Matters: While book value alone isn't sufficient for valuation, it provides a baseline measure of the company's tangible worth.

4. Earnings Capacity

Description: The company's ability to generate and sustain profits over time.

- **Key Considerations**:
  - Historical earnings trends.
  - Adjustments for non-recurring expenses or extraordinary income.
  - Comparison to industry averages or competitors.

Why It Matters: Consistent and strong earnings are a key driver of business valuation, often considered under the income approach.

5. Dividend-Paying Capacity

Description: The ability of the company to distribute dividends to its shareholders, whether or not it actually does so.

- **Key Considerations**:
  - Free cash flow available for distribution.
  - Reinvestment needs and company growth objectives.
  - Dividend history and policies.

Why It Matters: Dividend-paying capacity indicates financial health and can significantly influence value, especially for investors seeking income.

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6. Goodwill or Intangible Value

Description: The intangible elements that contribute to a company's value, such as reputation, brand recognition, customer loyalty, and intellectual property.

- **Key Considerations**:
  - Existence of proprietary technology or patents.
  - Long-term customer relationships and contracts.
  - Brand equity and market perception.

Why It Matters: Strong goodwill enhances value, especially for businesses with limited tangible assets but significant market influence.

7. Stock Sales and Size of the Block

Description: Considers past sales of the company’s stock and the proportion of ownership being valued.

- **Key Considerations**:
  - Historical stock transactions and their pricing.
  - Whether the shares represent a minority or controlling interest.
  - Discounts for lack of control or marketability.

Why It Matters: A controlling interest is more valuable than a minority interest, and illiquid shares often require discounts.

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8. Market Conditions

Description: Examines external economic and financial market factors that affect the business's valuation.

- **Key Considerations**:
  - General economic conditions (e.g., inflation, interest rates, or unemployment).
  - Availability of financing for buyers.
  - Recent sales of comparable companies in the same sector.

Why It Matters: Favorable market conditions can increase valuation, while unfavorable ones can dampen investor confidence and reduce value.

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Methods of Valuation

1. **Income Approach**
   - Discounted Cash Flow (DCF) for future income potential
   - Capitalization of earnings for steady income streams
2. **Market Approach**
   - Comparable transactions
   - Guideline public company
3. **Asset-Based Approach**
   - Net asset value for tangible assets

1. Income Approach

Discounted Cash Flow (DCF) for Future Income Potential

Description: DCF calculates the present value of expected future cash flows using a discount rate that reflects the business's risk profile.

- **Key Considerations**:
  - Forecast of future revenues and expenses.
  - Determination of an appropriate discount rate, Weighted Average Cost of Capital (WACC) or Cost of Equity.
  - Incorporation of terminal value to account for income beyond the forecast period.

Why It Matters: Ideal for businesses with predictable future cash flows or growth potential, the DCF method is highly detailed and widely regarded for its accuracy.

1. Income Approach

Capitalization of Earnings for Steady Income Streams

Description: This method capitalizes a single period's normalized earnings by dividing them by a capitalization rate (which reflects the risk and expected return).

- **Key Considerations**:
  - Stability and consistency of historical earnings.
  - Adjustment for non-recurring items and anomalies in financial performance.
  - Determination of an appropriate capitalization rate.

Why It Matters: Useful for businesses with stable, ongoing earnings, providing a simpler alternative to DCF for less volatile operations.

2. Market Approach

1. **Comparable Transactions**

Description: This method looks at recent sales of comparable companies to determine the value of the subject business.

- **Key Considerations**:
  - Identification of businesses in the same industry, size, and geographic location.
  - Adjustments for differences in revenue, profitability, or operational scale.
  - Availability and reliability of transaction data.

Why It Matters: Offers a market-driven perspective, reflecting what similar businesses are worth in real-world transactions.

2. Market Approach

2. Guideline Public Company Method

Description: This method compares the subject business to publicly traded companies in the same industry, using market data to determine value.

- **Key Considerations**:
  1. **Selection of Comparable Companies**:
     - Choose publicly traded companies similar in industry, size, and operational scope.
     - Ensure comparables are actively traded for reliable pricing data.

Why It Matters: Provides a transparent valuation framework based on real-time market data. Aligns the valuation with investor and market expectations. Particularly useful for benchmarking private companies against larger, publicly traded peers.

3. Asset Approach

The asset-based approach values the business based on the net worth of its tangible and intangible assets.

Net Asset Value for Tangible Assets

Description: Calculates the business's value as the difference between the total value of its assets and liabilities.

- **Key Considerations**:
  - Accurate valuation of tangible assets such as equipment, inventory, and property.
  - Deduction of all liabilities, including debt and contingent obligations.

Why It Matters: Useful for asset-heavy businesses (e.g., manufacturing, real estate) or liquidation scenarios.

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Discount for Lack of Control (DLOC)

What is DLOC?

- A valuation adjustment applied to reflect the reduced value of a minority ownership interest in a business due to the lack of control over key decisions.

Some Key Factors Affecting DLOC

1. **Voting Rights**: Limited or no ability to influence major decisions like mergers, acquisitions, or dividend policies.
2. **Operational Control**: No input in management or operational strategies.
3. **Sale of Assets**: No authority to sell assets or change the direction of the company.
4. **Market Comparisons**: Size and influence of comparable minority interests in similar businesses.

Discount for Lack of Marketability (DLOM)

What is DLOM?

- A valuation adjustment applied to reflect the reduced value of an ownership interest due to the difficulty of selling or converting it to cash.

Key Factors Affecting DLOM

1. **Liquidity**: The time and effort required to sell the interest in the market.
2. **Market Conditions**: Availability of buyers and overall demand for the ownership interest.
3. **Restrictions on Sale**: Contractual, legal, or operational limitations on transferring ownership.
4. **Company Size and Stability**: Smaller or riskier businesses may require larger discounts.

Importance of Business Valuation in Estate Planning

Key Applications

- Minimizing estate taxes
- Funding trusts or gifting strategies
- Equitably dividing assets among heirs
- Preparing for potential liquidity events

Minimizing Estate Taxes

Description: A well-executed business valuation ensures the estate's assets are valued accurately to avoid overpayment of estate taxes while staying compliant with IRS regulations.

Key Points:

- Establishes a defensible fair market value to reduce tax exposure.
- Allows strategic planning, by gifting or transferring shares at the current valuation to minimize future taxable growth.
- Prevents disputes or penalties from IRS audits.

Why It Matters: Proper valuation can significantly reduce the financial burden on the estate, preserving more wealth for heirs.

Funding Trusts or Gifting Strategies

Description: Business valuation is essential for structuring trusts or implementing gifting strategies to transfer wealth efficiently.

- **Key Points**:
  - Enables accurate determination of the value of shares or ownership interests being transferred to family members or trusts.
  - Supports tax-efficient gifting by leveraging annual gift tax exclusions and lifetime exemptions.

Why It Matters: Accurate valuations ensure compliance and maximize the use of tax exemptions, protecting family wealth.

Equitably Dividing Assets Among Heirs

Description: When a business is part of an estate, valuation ensures fair distribution among heirs, especially when some heirs may not want to participate in the business.

- **Key Points**:
  - Provides a clear basis for dividing assets equitably among heirs with different interests.
  - Allows for buyouts or compensatory arrangements for heirs not involved in the business.
  - Reduces the potential for family disputes by ensuring transparency and fairness.

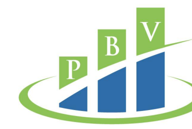
Why It Matters: Valuation helps avoid conflicts and ensures all parties receive their fair share.

Preparing for Potential Liquidity Events

Description: Estate planning often requires liquidity to pay estate taxes, settle debts, or support buyouts. Valuation informs strategies to generate necessary funds.

- **Key Points**:
  - Helps identify assets that can be sold or leveraged for liquidity.
  - Ensures the business's value aligns with funding needs for estate taxes or family payouts.
  - Supports planning for life insurance or business continuation agreements to cover liquidity requirements.

Why It Matters: Planning for liquidity ensures the business or other significant assets don't need to be sold hastily at a discounted value.



Strategic Uses of Business Valuation in Estate Planning

- Structuring buy-sell agreements
- Gifting shares or interests to family members
- Establishing family trusts
- Creating fair inheritance distributions

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Case Study

Scenario: Valuation for Estate Transfer of a Family-Owned Business

Brief Overview of the Business

- **Type**: A first generation family-owned machine shop
- **Size**: Annual revenue of $15 million with $2.5 million in EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization).
- **Ownership Structure**: Owned 100% by the founder, who is transferring the business to three children through a combination of gifts and trusts.

Case Study

Goals:

1. Minimize estate tax exposure.
2. Ensure fair division among heirs while keeping the business operational.
3. Plan for future growth and management continuity.

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Case Study

Selected Valuation Approach

- **Method**: **Income Approach (Discounted Cash Flow)** combined with **Market Approach (Comparable Transactions Method)** for cross-checking.
- **Steps**:
  - Projected cash flows for 5 years based on historical performance and industry growth.
  - Applied a discount rate of 17%, reflecting the business's risk profile.
  - Reviewed comparable public companies in the machine shop sector to validate multiples (e.g., EV/EBITDA of 4.5x).
- **Outcome**: The business was valued at **$11.5 million** on a controlling interest basis.

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Case Study

Discounts Added

- **Discount for Lack of Control (DLOC)**:
  - Applied a 15% discount for the minority interest being transferred, as each child was receiving a 33% ownership stake.
  - Adjusted value: $9.78 million ($11.5M - 15% DLOC).
- **Discount for Lack of Marketability (DLOM)**:
  - Applied an additional 20% discount due to the illiquidity of shares in a privately held business.
  - Adjusted value: $7.8 million ($9.78M - 20% DLOM).

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Case Study

Gifting Strategy

- **Step 1: Transfer Ownership Through a Family Limited Partnership (FLP)**:
  - The business owner transferred the manufacturing company's shares into an FLP, retaining a 1% general partner interest and distributing 99% as limited partner interests.
  - The FLP structure allowed for centralized control while enabling incremental gifting of limited partnership shares to heirs.
- **Step 2: Annual Gifting Using Exclusions**:
  - Used the **annual gift tax exclusion** ($19,000 in 2025) to gift limited partnership shares to each of the three children and their spouses, without incurring gift taxes.
  - Continued this annual gifting strategy over multiple years to maximize the transfer of ownership tax-free.

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Case Study

Step 3: Discounting for DLOC and DLOM:

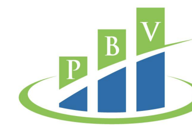
- Applied a combined **35% valuation discount** (15% for lack of control, 20% for lack of marketability) to the limited partnership interests.
- This reduced the appraised value of the gifted shares, increasing the amount of ownership that could be transferred tax-free.

Step 4: Leveraged Lifetime Exemption for Remaining Transfer:

- Used the business owner's remaining **lifetime estate and gift tax exemption** ($13.91 million in 2025) to transfer the remaining shares without triggering a gift tax.
- The discounted valuation allowed more shares to be transferred within the exemption limit.

Outcome (Case Study)

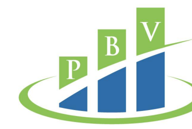
- **Tax Efficiency**:
  - Combined annual exclusions and lifetime exemptions to transfer substantial value without incurring immediate gift tax liability.
  - Valuation discounts for DLOC and DLOM reduced the taxable value, maximizing the shares transferred within the exemption limits.
- **Heir Benefits**:
  - Equitable ownership distribution among heirs.
  - Limited partnership structure preserved centralized control while enabling passive ownership for non-involved heirs.
- **IRS Compliance**:
  - The strategy was backed by a professional valuation report and structured to meet IRS guidelines, minimizing the risk of disputes or audits.



Lessons Learned (Case Study)

Lessons Learned

- **Valuation Strategy**: Combining income and market approaches provided a defensible valuation.
- **Discounts**: Proper application of DLOC and DLOM significantly reduced estate tax liability.
- **Planning**: Gifting through trusts allowed for tax-efficient transfer and business continuity.



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Recap: Key Takeaways

- **Valuation is essential for fair and effective estate planning**
- **Accurate valuations protect against tax and legal disputes**
- **Understanding the process ensures smoother family transitions**

“A well-executed valuation isn’t just a number; it’s a tool to safeguard your legacy and provide peace of mind for the future.”

Questions?

By: Sean Parrish, CVA, MAFF, CVGA
Email: sparrish@parrishvaluation.com
Office Phone: 401-526-0262
Cell: 401-474-3394

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