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Valuing a Closely Held Business

For many small business owners, valuing a **closely held business** is an important part of estate and financial planning. Because valuation is a multi-faceted endeavor, a comprehensive approach is needed. Equity interests in a closely held business are not frequently sold or otherwise transferred, which can make it difficult to ascertain a valuation. Therefore, valuing a business (a **sole proprietorship**, a **partnership**, or a **corporation**), involves an analysis of specific conditions that can affect closely held businesses.

Getting Down to Business

Whenever there is a need to perform a business valuation for estate purposes, there are potentially seven areas that must be researched in order to arrive at a fair value for the total business. Each area may address issues that are somewhat abstract and/or difficult to quantify. Here is a general overview:

1) The nature, scope, and history of the business operation must be reviewed. The product or service rendered must be evaluated by past performance, as well as the risks inherent in all phases of operations. While disregarding past events that are unlikely to recur, capital structure, sales records, growth, and diversity of operations can speak volumes about the past and even future performance of the business.

2) By analyzing both related business sectors and current economic conditions, an appraisal can be made regarding the future potential for business profits. Generally, the greater the expectation of profits, the greater the value of the business. The appraiser should evaluate the industry, as well as the position of the particular business within the industry. The economic climate may impact the ability of all businesses to generate profits. Often, insight can be gained from looking at several competitors' past performance and future growth potential.

3) Book value, defined as assets minus liabilities, is readily obtained from the balance sheet. However, in most cases, balance sheet adjustments according to book value will need to be made for an accurate reflection of economic versus tax depreciation.

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Donating Vehicles to Charity

Donating a vehicle is a great way to benefit a charity *and* reduce your tax liabilities. As with most tax benefits, however, Internal Revenue Service (IRS) regulations apply. Following the rules can help ensure that you receive a tax deduction for your good deed.

The charity you choose to donate your car to must be a ***qualified*** charitable organization. Most charities should be able to tell you if they are qualified organizations. In addition, IRS *Publication 78* lists most qualified organizations, which fall under nonprofit charitable, education, and religious categories. For more information about a particular charity, you may want to review their financial statements ahead of time. You are entitled to be informed of how your contribution will be used, as well as what percentage of the donation will be used for charitable purposes and what percentage will be used for administrative costs.

Taking Deductions

Determining the amount you can deduct for donating a vehicle to a charitable organization of your choice is dependent on several factors. For instance, your donation must be a **qualified vehicle**, which is defined as any motor vehicle primarily for use on public streets, roads, and highways; a boat; or an airplane. But, if the vehicle is part of a vehicle dealer's inventory and is for sale to customers, it would not be considered a qualified vehicle. To donate a nonqualified vehicle, review IRS *Publication 526* for the rules and limits that apply for property donations.

Generally, the amount you may deduct for a vehicle contribution depends upon what the charity does with the vehicle as stated in the **written acknowledgment** you receive from the charity for your donation. Typically, charitable organizations sell donated vehicles. So if the vehicle is sold, your deduction is limited to the gross proceeds from the sale. Keep in mind that many charities wholesale donated cars and may receive less than market value. In the event the charity retains the vehicle for its own use, the taxpayer is responsible for substantiating how the vehicle will be used and for how long.

A Closer Look

Prior to the 2004 reform, taxpayers could write off a car's full Blue Book value, regardless of the amount the charity actually received for the car. Today, however, when you donate a vehicle worth more than $500, you may deduct only the amount the charity receives for the sale of the car. While the written acknowledgement will depend on what the charity does with the vehicle, certain information must be provided, including:

1. Your name and taxpayer identification number
2. The vehicle identification number
3. The date of the contribution, and one of the following:

- a statement that no goods or services were provided by the charity in return for the donation, if that was the case
- a description and good faith estimate of the value of goods and services, if any, that the charity provided in return for the donation, or a statement that goods or services provided by the charity consisted entirely of intangible religious benefits, if that was the case.

Since your deduction is limited to the gross proceeds from a sale, the following must also be included in the written acknowledgement:

- a statement certifying that the vehicle was sold in an arm's length transaction between unrelated parties
- the date the vehicle was sold
- the gross proceeds received from the sale, and a statement that your deduction may not exceed the gross proceeds from the sale.

These vehicle donation rules only apply when the deduction exceeds $500. It is important to note that if all the required information above is not stated in the written acknowledgement, your deduction may not exceed $500.

Donating a car or other vehicle can be a wonderful gift to the charity of your choice, while providing you with an additional deduction for your taxes. However, abiding by the "rules of the road" can help smooth the way. Remember to check all the vehicle donor responsibilities carefully as specified in various IRS online publications at www.irs.gov. Be sure to also consult your qualified tax professional about your situation.

valuing a closely held business

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4) Profit and loss statements must be scrutinized to determine the company's earnings history. While the Internal Revenue Service (IRS) may require the past five years of profit and loss statements, for example, the agency generally will not respect five-year earnings averages, due to the belief that averages do not indicate realistic valuations. It is common for appraisers to "capitalize" earnings as a means of reducing future income to a single number, otherwise referred to as present value. Capitalizing earnings is a method used to determine how much an individual will pay for a business given the level of risk involved. Typically, the greater the risk, the less the buyer will pay, and vice versa.

5) Where appropriate, the dividend-paying capacity of the company will be determined from financial statements. However, dividends may not be a reliable criterion of market value for a closely held company since the controlling stockholders may have used discretion in opting to pay deductible salaries and bonuses, rather than nondeductible dividends.

6) The most difficult area for valuation purposes is goodwill, or the ability of a business to earn a return over and above what it could on its fixed assets alone. Consumer satisfaction, trust, and trademarks may be important factors in gross revenues. In addition, intangible goodwill value can be based upon location, reputation, or clientele. While it may be difficult to determine a precise valuation, an independent appraiser may be able to discern the overall significance of the company's goodwill.

7) If shares were purchased in the last three years, for example, the price paid for an interest in the business may be a significant factor in valuation for a closely held business. In this case, the IRS may scrutinize when the sale was made, whether the interest sold was controlling or a minority block, and whether or not the sale was forced by other conditions in the business or circumstances associated with the buyer or seller.

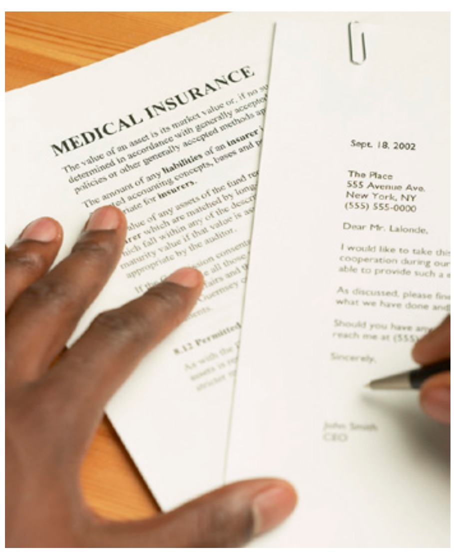
Wherever possible, each area must be reduced to specific numerical values. The IRS cautions against averages to prevent the appraiser from simply averaging factors, such as book value, goodwill, and capitalized earnings, and then coming up with a figure. Courts generally agree with the IRS in not giving credence to averages and formulas. As a result, valuation has become more complicated.

While determining the valuation of a closely held business may seem overwhelming at first, it may prove useful in estate and financial planning, as well as **business succession planning**. Because the valuation process is intricate and involves many variables, be sure to consult with qualified professionals.

Continuing Health Care Coverage with COBRA

Under the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA), employers with more than 20 employees that maintain a group health insurance plan are required to provide employees with an option to remain covered by the employer's plan for a specified period of time, if the employees or their family members lose coverage upon the occurrence of certain events (such as the death of the covered employee and reduced or terminated employment).

However, it's important to note that COBRA provides for continued coverage under the employer's *existing* plan, not a new plan. So, employees who previously did not elect coverage for themselves, their spouses, or their dependents may not elect continuation coverage that is broader in scope than what was provided during their employment.



COBRA coverage comes with specific rules governing who qualifies as a "covered employee" and the length of time coverage will be provided. Be sure to consult with the benefits administrator at your company to fully understand the plan rules.

Can a Living Trust Replace Your Will?

When planning your estate, you may consider setting up a **revocable living trust**. A properly managed revocable living trust can provide unique benefits; however, it does not completely replace a **will**. In determining whether this type of trust is appropriate for you, it helps to understand the overall benefits and tradeoffs of this estate planning tool.

A revocable living trust is created during your lifetime, and you can alter it in any way, and at any time. One key feature is that it allows you to retain control of the management and distribution of your assets.

The Probate Connection

Many people establish a revocable living trust to avoid **probate**, which is the legal process of settling your estate. Assets distributed from a trust upon your death *do* avoid probate. However, the probate process itself is not as burdensome for many estates as in the past. Many states have adopted the Uniform Probate Code, which greatly simplifies the process for many small- to medium-sized estates.

But, even with these improvements, the probated assets in your estate still become a matter of public record, which may raise privacy concerns. Avoiding probate may also be appropriate if you own properties outside your state of domicile, which may involve multiple probate proceedings.

Once you set up a revocable living trust, you must transfer your assets into the trust. Failing to do so will subject your assets to probate. Simply signing a trust document *without* retitling assets renders your living trust useless.

Do I Still Need a Will?

The short answer is yes. Generally, a revocable living trust cannot entirely replace the need for a will. There are some assets you may not wish to place in a trust. For example, it may be impractical to transfer tangible personal property such as automobiles, furniture, and jewelry to a trust. Consequently, some of your assets will remain outside your trust, making a will necessary to name your intended beneficiaries of those particular assets. If you have minor children, a will may also be used to designate a **guardian** for them.

Other assets may require special consideration. For example, retirement plan accounts (Individual Retirement Accounts (IRAs), 401(k)s, and profit-sharing plans) cannot be retitled to a living trust, although you could change the beneficiary designation to the trust. However, naming someone other than a spouse as beneficiary of a qualified retirement plan often requires spousal consent, because in many states, spouses now have rights to retirement plan benefits. In addition, naming your trust, rather than your spouse, as the beneficiary of your qualified retirement plan may have income tax consequences at the time of your death.

Trusts and Taxes

Your legal professional can help you examine all the variables affecting your property—the *type* of assets (e.g., real estate, life insurance, bank accounts, savings, business interests, and personal property), *where* they are located, and *how* they are titled to determine if a revocable living trust can help you meet your short- and long-term estate planning goals.