

The Art of Appraisals in Family Business Transitions

~ Thomas J. McLaughlin

Did you know that with proper planning, a qualified business appraisal, and legal counsel that is knowledgeable in the art of appraisals, a business owner could save significant tax? With an informed understanding of the business, the business's governing documents, and the fundamentals of industries in which the business operates, a qualified business appraisal can create tremendous transfer tax savings to business owners and to the estates of deceased business owners. Even better results are likely to occur when that business owner prepares and implements a business succession plan with an understanding of the technical components of the business appraisal, which may be closely reviewed by the IRS. We routinely work closely with our clients and the appraisers to make sure that a thorough appraisal report is received, while keeping a careful watch on how certain transaction aspects can materially affect the tax consequences of the parties involved.

When Is an Appraisal Required?

You can utilize an appraisal of your business interests in many contexts. Business appraisals for tax, however, are most common in the following circumstances: (i) when a sale or gift of a closely held business interest occurs between family members, (ii) when an owner in a closely held business interest passes away, (iii) when entities merge or otherwise consolidate, and (iv) when a business is owned partially or completely by an employee stock option plan.

How Do You Choose the Right Appraiser?

Select an appraiser who has an appraisal certification and experience with the type of property you need to have appraised. Depending on the assets involved in your business, you may need to engage two separate appraisers, with one appraiser valuing assets owned by the company and the other valuing the business interest involved in the transaction. For example, if you own a business that holds a commercial building with multiple tenants, engage an appraiser who regularly values commercial real estate to value the building, and engage a separate appraiser to value the business interest.

Is There an Art to Appraisals?

There is no single formula for determining the value of an asset, so an appraisal is more art than science. The IRS guidance provides that an asset's fair market value be determined as the price a willing, knowledgeable buyer would pay to a willing, knowledgeable seller when neither is under the compulsion to buy or sell the asset involved in the transaction. This means an appraiser must consider the facts and circumstances available regarding your business asset and apply judgment to determine the asset's fair market value.

What Factors Does the Appraiser Consider?

Many variables are involved in calculating the value of a business's assets and the value of an ownership interest in the business. The type of business being valued can affect which variables are more heavily weighted in the appraiser's analysis. Here are some of the factors that an appraiser will consider.

Commercial Property Appraisal Factors:

In a business holding commercial property, the appraiser will consider the following factors: (i) the type of property, (ii) the potential uses of the property, (iii) the term remaining on the leases (including extensions), (iv) the likelihood that the tenants will remain in place, (v) whether the rent is at, above, or below market, and (vi) the community surrounding the property. The appraiser will also consider many other factors unique to that property when determining the property's fair market value.

Sales or Service Business Appraisal Factors:

In a service- or sales-related business, the appraiser is likely to consider the following factors: (i) customer lists, (ii) age and upkeep of equipment, (iii) inventory, (iv) transferability of existing contractual relationships, (v) ability to retain key employees and management, (vi) status of patents and trademarks, (vii) barriers to entering the business, (viii) licensure requirements, and (ix) market share, as well as other factors.

General Factors Involved in Valuing the Entity:

After reviewing factors specific to the business's assets, the common factors the business appraiser examines will include (i) the financial performance, (ii) the liquidity of assets, (iii) the diversification of assets, (iv) the management experience, (v) the outlook for the business, (vi) whether a formal distribution or capital call policy is in place, (vii) the history of capital calls and distributions, (viii) any recent offers to acquire the company or an interest in the company, and (ix) the history of past transactions involving ownership interests. Once he or she has completed this examination, the appraiser will review several factors specific to the ownership interest being conveyed, including (i) the restrictions on sale or other transfer, (ii) the likely holding period, and (iii) the voting influence of the interest.

Whether the appraiser is valuing a controlling interest in the business, an ownership interest subject to substantial transfer restrictions, or a business interest with a limited market of purchasers can have a significant influence on the appraised value of the business interest. Depending on the facts and factors, the total combined discounts available to the business owner can range from below 10 percent to above 50 percent.

What Valuation Approaches Might the Appraiser Consider?

Three basic valuation approaches are promulgated by the American Society of Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuators and Analysts: the income approach, the cost approach, and the market approach. The income approach establishes the value of an

asset by calculating the present value of the asset's future economic benefits. The cost approach establishes the value of an asset by determining the cost of reproducing or replacing the asset and then deducting an amount for depreciation that has occurred due to physical deterioration or functional and economic obsolescence. The market approach establishes the asset's value by focusing on recent transactions involving similar assets and then makes adjustments to those transactions based on differing characteristics between the assets.

The income and market approaches are commonly used to determine the value of operating businesses and cash-flowing properties, while the cost approach is usually applied when an asset is new, in a holding company context, or to establish a floor value by way of liquidation. When applying the income approach, the appraiser will develop an indication of value by discounting or capitalizing future cash flows through an application of an expected rate of return commensurate with the risk involved with the asset or business. Determining the discount rate and capitalization rate to be applied means that the appraiser will examine the market data to create a range of reasonableness. The appraiser will then weigh all of the information available regarding the market data and asset being valued to conclude a discount rate and capitalization rate. With these rates set, the appraiser will project out future cash flows and discount them back to a present value using the determined discount rate. The appraiser will also determine a normalized net operating income of the asset and divide this by the concluded capitalization rate to determine the asset's fair market value. Under the market approach, the appraiser will examine transactions involving similar assets or companies and establish a pricing multiple, considering differences in the investment characteristics.

[What Are the Common Discounts/Premiums Applied?](#)

The courts and the IRS recognize that discounts for lack of control and lack of marketability are appropriate when valuing the ownership of a minority interest in an asset. An appraiser will examine the many characteristics of the ownership interest when determining the magnitude of the lack of control discount, including the ability to (i) make management decisions, (ii) bind the company to a contract, (iii) make distributions or require contributions, (iv) buy, sell, or borrow against the company's assets, (v) amend the company's governing documents, (vi) force the sale of a controlling interest, and (vii) select officers, directors, and employees of the company. If the interest being appraised is a controlling interest, then a control premium—a price above the freely traded minority-interest share price—will be determined based on the level of control associated with the interest. The appraiser will then determine the size of the lack of marketability discount associated with the ownership interest by reviewing (i) the distribution capacity and policy of the company, (ii) the quality and liquidity of the assets and business operations, (iii) any specific rights or restrictions, including transferability of the ownership interest, and (iv) the liquidity and availability of a market for the ownership interest.

What Is the Impact of Strategic Planning on an Appraisal?

Keeping the foregoing in mind, the strategic planning you can complete with your legal counsel through a business succession plan can cause a significant impact on the discounts and possible premiums that an appraiser may apply throughout the valuation process. This impact can exceed 30 percent of the value of an owner's interest in a business entity, depending on the level of control over the interest, transfer restrictions placed on the interest, and market of purchasers for the interest.

What Is the Impact of an Appraisal on Taxes?

An appraisal can have a significant impact on taxes faced by the parties involved in the transaction. The taxes that can be affected include income, estate, and gift taxes. Depending on the transaction's structure, the impact of the taxes could be immediate or delayed and may have both positive and negative effects for different parties. Consequently, it is imperative that you hire an attorney who understands the art of appraisals in business succession planning matters, including how the planning will affect the tax consequences of those involved. To better illustrate some of the effects that an appraisal can have on the taxes you face, let's look at a few examples. For illustration, we will look at how an appraisal impacts a fictional person named Tim.

Gift Tax Impact:

Tim, a widower, wants to gift each of his three children 25 percent of his family business. Tim does not want to pay any gift tax on the transfer but instead use his federal gift tax exemption equivalent (\$5,450,000) to the extent possible.

Tim's gift will require a business appraisal for gift tax reporting purposes. The business appraisal must contain a valuation of the assets owned by the company so the gifted interests can be properly valued and reported to start the running of the statute of limitations.

Tim's business owns one leased building initially valued at \$13,000,000. When they review the draft appraisal report, Tim and his advisors notice that the appraiser did not include in the analysis certain tenant risks and leasing matters they are aware of. After providing the appraiser with this additional information, the appraiser reassesses the discount rate and capitalization rate, which results in minor adjustments to those rates but a significant adjustment to the value of the building, reaching a final concluded value of \$11,000,000—a full \$2,000,000 less than the original appraisal of the building.

The final property valuation is then provided to a qualified business appraiser. The business appraiser reviews the business's governance documents with its other assets and liabilities and determines an undiscounted value of the business of \$11,000,000. Considering all of the factors discussed above, the business appraiser initially concludes that the fair market value of the 25 percent interests proposed to be transferred is \$2,000,000, after applying a lack of control discount and lack of marketability discount (a combined discount of nearly 28 percent). Upon reviewing the reasonable ranges and other available information in the report, Tim and his advisors note that

the appraiser's information regarding the limited liquidity of assets, lack of diversification of assets, distribution policy in place, the limited voting influence of each 25 percent block, and the restrictions on sale or other transfer is incomplete and that the appraiser requires additional information. After considering this additional information, the appraiser concludes that the fair market value of each 25 percent interest is \$1,800,000—or \$5,400,000 in total for gifting purposes—after applying an increased lack of control discount and lack of marketability discount (a combined discount of nearly 35 percent).

Because of his planning and thorough review of the appraisals, Tim can gift a 25 percent interest to each of his children, which will utilize almost all of his available equivalent exemption. If Tim and his advisors had accepted the initial appraisal drafts without review, Tim would have only been able to transfer approximately 19.25 percent interests to each of his children without incurring gift tax, leaving Tim with a 42.25 percent interest and Tim's estate with approximately \$860,000 (assuming a 40 percent tax rate) in additional estate tax. The estate tax savings could be even larger if the business continues to appreciate following the gift.

Estate Tax Impact:

Had Tim died before completing the gift transaction, Tim's personal representative would have needed to value Tim's business for estate tax purposes. As Tim would have owned 100 percent of the business and had full control over all decisions made by it at the time of his death, the IRS would require the business to be valued without discounting, as all of the assets were held by Tim directly. Had the initial commercial property appraisal been accepted without review, the value of the business would be \$13,000,000. Instead, upon thorough review and analysis, the value of the business's assets were concluded to be \$11,000,000, resulting in an estate tax savings of \$800,000.

What Is the Real Difference Here?

If we focus on the difference in estate taxes between the two scenarios we just looked at—the first being that Tim completed a business succession plan before his death, gifting the majority of the business to his children, and the second being that Tim died while still retaining 100 percent ownership of the business—we can see the real savings you can realize if you complete a succession plan under circumstances similar to Tim's.

With the reviewed appraisals, Tim could transfer 75 percent of his business to his three children without incurring gift tax. Tim's remaining 25 percent interest was valued at \$1,800,000 and would cause approximately \$720,000 of estate tax. Had Tim died owning 100 percent of the business, the business's value upon review of the appraisals would have been \$11,000,000. To make the comparison accurate, the business's value must be reduced by the same \$5,400,000 exemption amount used in Tim's gift above, resulting in a value of \$5,600,000 being utilized for estate tax comparison purposes. Tim's estate would have incurred \$1,520,000 of additional estate tax if the business succession plan had not been completed before Tim's death.

*If Tim's Spouse Had Survived Him,
Would the Appraisal Have a Different Outcome?*

Yes. If Tim's spouse, Mary, had survived Tim, and Mary received all of Tim's assets either outright or in further trust, resulting in no estate tax at Tim's death, the focus on reviewing the appraisals would be tailored more to confirming that the approaches taken by the appraiser were accurate, but with a mindful eye that a more significant value does not create additional estate tax at Tim's death—and may lead to increased deductions or lower gains being recognized in an ultimate sale transaction. Tim and his advisors should still work closely with the appraisers to make sure that the capitalization rates, discount rates, control premium, and discounts for lack of control and lack of marketability remain reasonable given the facts, and they should provide any information they think is necessary for the report to be complete. As long as it would be appropriate under the facts and circumstances, a higher valuation conclusion would be better because increased deductions or lower gains may be recognized in an ultimate sale transaction.

Conclusion

Hiring a qualified appraiser and legal counsel knowledgeable in the art of appraisals is critically important to you and other business owners because of the large tax impact the appraisal may have on you and your family. Your legal counsel should ensure that all of the information is contemplated, especially when you consider that, often, only slight adjustments well within the reasonable range of available and similar transactions can have a significant impact on the tax consequences. We always enjoy the chance to work closely with our clients and their selected appraisers to make sure all of a transaction's factors are closely weighed and presented in a carefully planned manner so the valuation reports will be clear and defensible if scrutinized by the Internal Revenue Service.



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He is a board certified specialist in tax law, focusing on business entities and individuals in tax, transactional, and succession matters. Tom has considerable experience in forming, operating, and terminating limited liability companies, partnerships, and corporations. He regularly advises clients on transfers involving business interests, whether by sale, gift, or estate administration, and the appraisals that may be required as a result of such transfers. Tom earned his LL.M. in Taxation, J.D. and M.S. Acc. from the University of Florida.

