Appraisal Insights: Gift and Estate Tax

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Focus of Presentation

- Overview of Appraisal Process
- Appraisal Basics
- IRS Areas of Focus

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Topics

- Process
  - The Assignment
  - Due Diligence
  - Report
- Appraisal Basics
  - Standard of Value and Basis
  - Income Approach
  - Market Approach
  - Asset Approach
- IRS Areas of Focus

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The Assignment

- What is (are) the valuations date(s)?
- What is the size of the interest?
  - 100%
  - 51% to 99%
  - Less than 50%
- Do you need a specialist for the industry?
- Making sure there are no conflicts – an independent appraiser

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Due Diligence

- The subject company will provide the appraiser with various financial, corporate, industry and other company information.
- An initial analysis is performed based on provided information, as well as data on economic, industry and market conditions as of the valuation date.
- A site visit and/or management interview is performed with key members of company management to get a detailed understanding of the company's operations, history, financial condition and outlook.

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Report

- What documents did the appraiser look at?
- Did the appraiser inspect location or facilities?
- Whom did the appraiser speak with?
- What data sources were relied on?
- Is the report complete in terms of sources relied on, and is the process used to determine the concluded value clearly explained and replicable by another party?

Appraisal Basics

Standard of Value

- Fair Market Value (FMV): The IRS defines FMV as “the price as which a property would change hands between a willing buyer and willing seller, when the former is under no compulsion to sell and the latter is under no compulsion to buy, and both parties have reasonable knowledge of the relevant facts.”

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Appraisal Basics

Control vs Minority Basis

- The ability to control a corporation is inherently more valuable than a minority investment.
- A controlling shareholder can appoint management; set management compensation; determine corporate policy; buy, sell or liquidate assets; sell the company or buy another company; and declare dividends.

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Appraisal Basics

- A value of something today is the present value of its future cash flows
- Value comes down to:

  - What return do you require to plunk money down today to get a return later?

  - These later returns are “cash flows” akin to dividends or selling that item to another person at a future date

Appraisal Basics

- Three Approaches to Value
  - Income Approach
  - Market Approach
  - Asset Approach

- All are based on the cash flow generating capacity of the assets of the company, both tangible and intangible

Appraisal Basics

- The appraiser analyzes historical and forecasted financial data to determine a normalized level of earnings or income
- Adjustments may be made to remove non-recurring or unusual items and adjust expense to normalized levels
- Multiples or capitalization rates are applied to these earnings streams

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Income Approach

- Income Approach
  - For every dollar of revenue generated, the higher the percentage left after all expenses have been paid and the company's **required reinvestment** is satisfied, the higher the value of the company.
  - Captures the cash flow generating capacity unique to that company

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Income Approach

Cash Flow:

	Adjusted Income
-	Increases in Working Capital
-	Capital Expenditures
+	Depreciation and Amortization
+	Change in Debt
	Free Cash Flow

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Market Approach

- Looks at similar companies and the price the market places on those companies
- These are typically observed in the marketplace
- Example:

Subject Company Earnings **$10.00 per share**

15 Companies in the industry sell at an average multiple of **10x** earnings per share

Value of Company: $10.00 x 10.0 = **$100.00 Per share**

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Market Approach

- The market approach consists of any/all of the following:
  - An analysis of previous sales or offers for the subject company's stock
  - Sales of entire public or privately held companies similar to the subject company
  - And/or sales of stock of publicly traded companies similar to the subject company

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Market Approach

- Multiples observed in the marketplace must be adjusted for differences in risk to cash flow and growth in cash flow
- Multiples are correlated with the size of the company and other risk/growth prospects

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Asset Approach

- Method based directly on the market value of the assets of the business, minus liabilities
- The asset approach may be appropriate for companies holding a large amount of tangible assets, or that may not be a going concern

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Asset Approach

- For operating companies, going concerns, and/or companies that have created significant intangible value, the asset approach is generally not appropriate
- It is typically less relevant in minority appraisals as minority shareholders cannot force the sale or distribution of assets

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Typical Focus Areas: IRS

- Appraisal Methods Used
- Weighting of Methods and Value Indications
- Discounts
  - Lack of Control
  - Lack of Marketability
- Tax Effecting
- Related Party Expense/Income
- Family Limited Partnerships

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Donny Springer specializes in engagements for ESOP-related valuation and financial advisory services and estate and gift tax valuations. He also has experience in assisting with appraisal engagements for a variety of other purposes.

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Mr. Springer is an Accredited Senior Appraiser of the American Society of Appraisers designated in Business Valuation and has completed Level I and Level II of the Chartered Financial Analyst (CFA) program administered by the CFA Institute. Mr. Springer earned his Bachelor of Science in Business Administration, Finance from Portland State University. He is a member of the ESOP Association, Membership Chair of The Northwest Chapter of The ESOP Association, and a Member of the ESOP Association's Valuation Advisory Committee. Mr. Springer is a frequent speaker on valuation and financial advisory matters at conferences and webinars sponsored by the National Center for Employee Ownership and the ESOP Association, as well as other groups on various appraisal topics.