

BDG Business Valuation Insight

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Successful succession
planning starts today

Make no mistakes —
the IRS means business

Valuing options:
Are you up for the challenge?

How to evaluate
a distressed business



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Successful succession planning starts today

American companies have been facing an economic crisis unparalleled since the Great Depression. While many businesses are worth less today than under more favorable market conditions, private business owners now can gift a higher percentage of the business to heirs without incurring federal gift taxes or estate taxes. There's no time like the present for business owners to start — or revisit — their succession plans. And now that sales are slower, owners might have time for rainy day projects, like succession planning.

Depressed values

Before you start drafting a succession plan, it's important to understand how tumultuous economic conditions affect market value. Variables that affect value include:

Expected cash flows. According to both the market and income valuation approaches, future earnings determine value. To the extent that a business experiences decreasing demand and/or rising prices, expected cash flows will be impaired. Historic financial statements may require adjustments to reflect reduced future expectations.

Perceived risk. Investors are uncertain about where the markets are heading. Particularly volatile sectors include construction, automotive-related industries, financial services and retail businesses. Greater risk results in higher discount rates (under the income approach) and lower pricing multiples (under the market approach), which translates into lower values. When selecting comparables, transaction date is an important selection criterion to consider.

Marketability. With a shorter supply of willing buyers and a plethora of willing sellers, selling a business today requires patience. In valuation terms, this decreased liquidity translates into higher marketability discounts.

When weighing in economic conditions, valuers take care not to be overly pessimistic. Valuations that double-count risk factors, or fail to recognize that economic conditions are cyclical and should someday improve, could undervalue your business.

Estate planning choices

Low business values present excellent planning opportunities for business owners and wealthy persons interested in



transferring asset values to the next generation. With each share of stock (or partnership unit) worth less than it would be in a bull market, a higher percentage of the business falls under the annual gift tax exclusion (\$13,000 in 2009) and the lifetime gift tax exemption (\$1 million).

Estate planning tools — such as family limited partnerships (FLPs) and family limited liability companies (FLLCs) — transfer assets to heirs while allowing donors to retain control over the business and receive distributions from income-producing assets.

Wealthy persons can transfer a variety of assets into these estate planning vehicles, including private business interests, real estate and marketable securities. Several 2008 taxpayer victories — including *Mirowski v. Commissioner*, *Holman v. Commissioner* and *Astelford v. Commissioner* — prove that FLPs and FLLCs can withstand IRS scrutiny if they are established for bona fide business purposes and operated in a manner consistent with their partner or member agreements.

As an added bonus, limited partner and member units may be discounted for their relative lack of control and marketability. Factors that affect the magnitude of valuation discounts include:

- Type of assets held,
- Financial performance of the underlying assets,
- Portfolio diversification,
- Leverage,
- Owner rights and restrictions,
- Distribution history, and
- Personal characteristics of the general partners or managing members.

Discounts vary significantly, but can reach (or exceed) 40% of the entity's net asset value, depending on case specifics.

Buy-sell agreements

Another important part of succession planning is the buy-sell agreement, which dictates what happens when an owner dies, becomes disabled or otherwise terminates his or her interest. Buy-sell agreements also give owners an idea of what the business is worth and prevent transfers to undesirable third parties.

Effective buy-sell agreements address the following valuation issues:

Definition of value. Most investors expect to receive fair market value for their interests. The buy-sell agreement also should indicate the appropriate “as of” date and basis of value (for example, minority or controlling, marketable or nonmarketable) for each owner and buyout scenario.

Valuation process. Disputes are likely if an outdated buy-sell agreement lists book value or a simplistic valuation formula as the means for determining value. A valuation professional provides an accurate, objective indication of value. Important considerations are how many appraisers to obtain and who pays the professional fees.

Buyout terms. Owners should consider how the company will fund future buyouts, including the duration of payments and the interest rate (if applicable), as well as any foreseeable tax implications.

Many companies fund buyouts with key-person life insurance. This insurance also allows the company to get back on its feet after losing an integral part of its

Family matters

Only about one-third of family businesses survive into the second generation, according to Family Firm Institute, a Boston-based professional organization. So, it's important for family business owners to realistically assess whether heirs possess the requisite desires and qualifications to run the show. If not, selling to an unrelated third party may be a more viable exit strategy.

When multiple heirs are involved, ownership transfers can lead to family feuds, even among formerly amicable siblings. Ideally, heirs should possess complementary skills and distribute work equally to improve the transition's chances of success. Or owners should consider dividing up the business — into asset groups or locations — and giving each heir his or her own “sphere of influence.”

For example, one retiring manufacturer gifted his daughter the factory, in which she was actively involved, and his son, who lived overseas, a passive interest in the underlying real estate. This simple solution proved optimal: Dad saw his business continue to grow, Sister earned a monthly paycheck and a stake in a private business, and Brother received monthly rent checks without hands-on involvement.

Valuators can help family business owners and attorneys customize solutions to meet their special needs. Beyond a business valuation, an appraiser can help divvy up the family business into logical pieces, allocate value and tackle complex tax issues.

management team. A valuator can help estimate the probable loss in productivity, the cost of finding a replacement and the value of the business to ensure adequate insurance coverage for each owner.

Perfect timing

Market values are down and the annual gift tax exclusion is up. And the longer an asset stays in a wealthy person's estate, the more it may appreciate — which increases the taxable estate. The timing is right for business owners to address their succession planning needs. And a valuator can help get the ball rolling. ●

