

Business Valuation Information

For Charitable Gifting Purposes

Written by:



Allied Business Group, Inc
7007 College Boulevard, Suite 400
Overland Park, KS 66211

Phone: 913-897-3599
info@AlliedBizGroup.com
www.AlliedBizGroup.com

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Introduction

When business owners think about giving to charity, a traditional cash donation often comes to mind. A better alternative may be gifting a portion of their company's privately held stock, yet many business owners are not aware of the advantages this structure can offer. It can provide a tax deduction similar to a cash donation, but it also preserves the donor's liquidity, as cash resources are not reduced. Arrangements can even be made to ensure that the donor will receive a lifetime income stream from the gifted stock.

This report was created by a business appraiser to better inform business owners, and their advisors, about business valuation and, specifically, the gifting of privately-held stock. This report will also discuss the various steps involved in completing a business valuation, while providing important information about key factors that increase or decrease the value of a company.

It is common for business owners to gift a portion of their business while considering a sale of the entire company. In this situation, it's very important to donate stock prior to entering into a binding agreement to sell. Once a binding agreement is in place, a gift may be characterized by the Internal Revenue Service as an "anticipatory assignment of income", which results in the gift being treated as a sale of stock, thereby resulting in a taxable capital gain on the appreciation of stock.

When conducting a business valuation for charitable gifting, the majority of valuation approaches require a discount for lack of control and/or discount for lack of marketability. The last section in this report provides the reader with information regarding these discounts, and how they can be reduced to maximize the tax benefits of gifting.

While information in this report is deemed to be correct, it is not intended to be a substitute for professional advice. Business owners should always consult with legal, tax and financial professionals to help determine their best options when considering any type of gift.

1.0 The Valuation Process

For gifts of closely held stock over \$10,000, the Internal Revenue Service requires a qualified valuation report to validate the value of the gift. Valuation reports are conducted by a qualified business appraiser and typically take three to four weeks to complete. The process starts with reviewing documents from the subject and interviewing the client and/or company management. From there, the appraiser conducts an economic and industry analysis, financial statement analysis, valuation analysis and reconciliation of values – all of which provide crucial information that will be used to create a credible and defensible business valuation report.

Engagement

The first step of a valuation involves defining the scope of the assignment. This includes defining the appraisal subject, the interest being gifted (100% interest, 15% interest, etc.) and the date of the gift.

During this stage, the appraiser and client sign an engagement agreement that outlines the scope of the valuation, estimated time to completion, the obligations of each party, relevant fees and any other pertinent information.

Obtaining Documentation

The second step of the process involves providing the appraiser with several documents:

- 3-5 years of historical profit and loss statements
- Current year-to-date profit and loss statement
- 3-5 years of year-end balance sheets
- Current balance sheet
- 3-5 years of historical tax returns
- Management forecasts (if available)
- Other documentation may include: inventory lists, asset lists, lease contracts, real estate appraisals, information on contingent liabilities and any other pertinent information that may help the appraiser fully assess the company.

Interview with Client

The appraiser will meet with the client and/or key managers for an in-depth interview about the subject company. The interview typically takes two to three hours to complete and covers a broad range of topics, including: a history of the business, the state of the industry, products and services offered, employee information, company's financial statements and balance sheets, real estate ownership and rental agreements. The interview can be done at the client's office, the appraiser's office or via conference call.

Economic and Industry Analysis

In addition to performing a careful analysis of the company, the appraiser will research the economy and its impact on the company's value. The appraiser will also research the company's industry, reviewing current trends, obstacles and other issues to determine how they affect the value of the business.

Financial Statement Analysis

The appraiser will compile the company's financial statements, based on the documentation provided, and then s/he will make normalizing adjustments to the financial statements to determine the true earnings of the business. All trends, discrepancies and points of interest that could influence the company's value will be identified and analyzed.

Valuation Analysis

There are three approaches to business valuation:

- Market Approach – determines the value of a business by using methods that compare the business or business interest to similar businesses that have sold in the marketplace.
- Income Approach – values a business based on the present value of its expected future cash flows.
- Asset (Cost) Approach – determines the value of a business by taking the fair market value of the company's assets, less the fair market value of its liabilities.

Several appropriate valuation methods, within each valuation approach, will be utilized based on the characteristics of the company and the scope of the appraisal report.

Determination of Relevant Discounts

Gifts of closely held stock are generally minority interests (less than 50 percent of the company's stock). When valuing these interests, the final value will generally be less than the pro rata share of a 100% interest in the company. The reason for this is that minority shares have an inherent lack of control and a lack of marketability applied to them. The appraiser will determine the amount of the discount to apply to the subject interest. The discount amount depends upon the degree of control and marketability of the gifted interest. [Note: these discounts, and factors that can decrease the discounts, are detailed in Section 4.0.]

Reconciliation of Values

To arrive at a final estimate of value for the gift of stock, the appraiser will reconcile the values derived in each of the valuation methods and combine them with appropriate discounts.

Creation of the Valuation Report

Once a value for the company has been determined, the appraiser will create a detailed report that compiles all of the data and analysis performed during the valuation process. The report will include:

- Information gathered through the interview with the client
- Economic and industry research and analysis
- Financial statement analysis
- Each of the valuation methodologies used and their resulting value
- Analysis of the appropriate discounts
- Analysis of the reconciliation to arrive at a final value for the gifted interest

2.0 IRS Reporting Information

There are some special reporting rules that the IRS requires for charitable gifts:

- If the value of a gifted interest in closely held stock exceeds \$10,000, a qualified appraisal report is required.
- The appraisal report must be completed no earlier than 60 days prior to the gift and no later than the date the return is due (with extensions).
- It is very important that business owners donate stock in their business before entering into a binding agreement to sell the company. Once a binding agreement is in place, a gift may be characterized by the Internal Revenue Service as an “anticipatory assignment of income”, which results in the gift being treated as a sale of stock, thereby resulting in a taxable capital gain on the appreciation of stock.
- The appraisal must be completed by a ‘qualified appraiser’ in accordance with generally accepted appraisal standards. A ‘qualified appraiser’ meets the following requirements: 1) The individual has either earned an appraisal designation or has met certain minimum education and experience requirements, 2) The individual regularly prepares appraisals for which he or she is paid, 3) The individual demonstrates verifiable education and experience in valuing the type of property being appraised and 4) The individual has not been prohibited from practicing before the IRS.

[The report also must meet the relevant requirements of Regulations section 1.170A-13(c)(3) and Notice 2006-96. Notice 2006-96, 2006-46 I.R.B. 902, is available at www.irs.gov/irb/2006-46_IRB/ar13.html.]

- The following link includes instructions from the IRS on completing Form 8283, Noncash Charitable Contributions. This form must be completed if the amount of deduction for all noncash gifts is more than \$500. <http://www.irs.ustreas.gov/pub/irs-pdf/i8283.pdf>

3.0 Factors Influencing a Company's Value

Most business appraisers agree that business valuation is a unique combination of art and science. Because there is no universal formula that can generate the exact value of a company, deriving the accurate worth of any business requires the consideration of many factors. Such factors include the earnings ability of the business and the risks of the business, among others.

Earnings

Earnings represent the benefits stream (owner's cash flow) to the owner of the business. Ultimately, the value of a business is determined by what someone would pay for it in the marketplace. Buyers look to purchase a future income stream that will provide a desired return on his or her investment, which will justify the purchase price. As a result, most appraisers base their valuations upon historical and future earning patterns of an operating business. This means that the easier it is for a potential buyer or other individual or entity (such as the IRS) to see the true earnings of the company, the more reliable those earnings will be – which increases the value of the business. To make earnings more transparent, business owners should reduce the amount of “owner perquisites” in their business. These are items that are being expensed by the business, but are a benefit to the owner and are not related or necessary to operating the business itself.

Risk Factors

Every company has unique risks associated with its operation, and appraisers must weigh the company's future opportunities against the perceived business and economic risks. Elements of the business that increase risk will decrease the company's value. By the same token, elements that decrease risk will increase the company's value. Some risk factors that influence value include:

- **Dependence on Key Employees** - One of the biggest risks in privately held businesses is dependence on one or two key employees, including the owner. By reducing the reliance on these key employees, the value of the business will be increased.
- **Diversification** - By diversifying the company's customers, suppliers, product lines and employee talent, a company reduces its risk.
- **Infrastructure** - A solid infrastructure of people and systems within a company helps decrease risk, thereby increasing a company's value. Talented managers, trained employees and established operational systems help the company run smoothly, allowing a more seamless transfer to a buyer.
- **Timing** - The value of a business depends on the timing of internal and external factors. Internally, a company has less risk if it displays a positive trend of historical financial performance. A positive earnings projection also decreases the company's risk. External factors, such as industry stability, market conditions and economic outlooks, all shape the company's future performance expectations.

- **Assets** - In an asset-intensive business, the conditions and efficiency of equipment affect the value of the company. Well-maintained equipment allows buyers to avoid replacement and repair costs. Likewise, the amount, and ability to protect, intellectual property or proprietary content will increase a company's value.
- **Appearances** - The way a company looks, both physically and on paper, affects the perception of value and risk to a buyer. The organization and efficiency of the working environment reflects upon the company and its overall management. Clean, organized financial statements will increase the confidence a buyer has in a company's actual performance.

4.0 Valuation Discounts

The value of a gifted interest in a closely held business is based on its 'fair market value'. Fair market value is defined by the IRS's Revenue Ruling 59-60 as 'the price a willing, knowledgeable buyer would pay a willing, knowledgeable seller when neither is under compulsion to buy or sell.'

Appraisals are accurate and relevant at a specific point in time. The effective date for a charitable contribution is the date the interest was gifted. Business valuations should only reflect information available up to the effective date. Events that occurred after the effective date should not be taken into consideration in the appraisal.

As mentioned earlier, gifts of closely held stock are generally minority interests (less than 50 percent of the company's stock). When valuing these interests, the final value will generally be less than the pro rata share of a 100% interest in the company. The reason for this is that minority shares have an inherent lack of control and a lack of marketability applied to them. The appraiser will determine the amount of the discount to apply to the subject interest. The discount amount depends upon the degree of control and marketability of the gifted interest.

The two discounts most commonly applied are a discount for lack of marketability (DLOM) and discount for lack of control (DLOC). [Note: these are defined in detail below.] The size of the discounts varies, depending on the individual characteristics of the gifted interest and the method of valuation used. The following table displays various valuation methods and the appropriate corresponding discounts.

Valuation Approach	Valuation Method	Applicable Discount - for Minority Interests
Income Approach	Discounted Future Earnings Method	lack of marketability
Income Approach	Capitalization of Earnings Method	lack of marketability
Market Approach	Direct Market Data (Transaction) Method	lack of control, lack of marketability
Market Approach	Guideline Public Company Method	lack of marketability
Asset Approach	Adjusted Book Value Method	lack of control, lack of marketability

4.1 Discount for Lack of Marketability

“A discount for lack of marketability (DLOM) is used to compensate for the difficulty of selling shares of stock that are not traded on a stock exchange compared with those that can be traded publicly.”¹ The discount is intended to reflect the market’s perceived reduction in value for not providing liquidity to the unit holder. DLOMs may also be appropriate when the shares have either legal or contractual restrictions placed upon them. This may be in the form of restricted stock, restrictions resulting from buy-sell agreements, bank loan restrictions or other types of contracts that restrict the sale of shares.

Factors Influencing the Discount for Lack of Marketability

The following factors influence the discount for lack of marketability and how they could potentially reduce the discount for lack of marketability. For the purposes of charitable gifting, donors want to reduce the discount for lack of marketability. This is because the discount for lack of marketability reduces the overall value of the gift, thereby reducing the tax deduction.

- **Put Rights** - One effective tool to increase the marketability of a minority interest is to issue a “put option” to the beneficiary. A put option gives the owner of the option the right to sell the minority interest at a specified price up to a predetermined time in the future. The put option should have a reasonable prospect of being enforced and funded, should the beneficiary wish to execute the option.
- **Prospects for liquidity** - The shorter the expected holding period, and the more certain the prospective transaction, the lower the discount. For example, if there are prospects for a public offering or sale of the business, the discount for lack of marketability would be lower than if there were no prospects for liquidity.
- **Transfer Restrictions** - Restrictions on transfers of the stock of the company make the stock less marketable because of the inherent difficulty in selling them.
- **Information Access and Reliability** - The degree to which information is or is not available to minority owners affects the discount for lack of marketability. The more available company information is to minority owners, the smaller the discount for lack of marketability will be.
- **High Dividend Yield** - Companies that pay dividends tend to be more marketable than companies that do not, resulting in a smaller discount for lack of marketability.
- **Size and Mood of the Market** - The larger the market is for the interest being valued, or imminent sale of the company, the smaller the discount for lack of marketability will be. The mood of the investing public also influences the marketability of the company. When the market is bullish, investors are more willing to invest, making the company easier to market and thus reducing the discount for lack of marketability.

¹ Trugman, Gary. “Understand Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses”. Third Edition. 2008. Pg 412-413.

- **Growth Prospects** - Companies that have positive growth prospects are easier to sell than companies that do not. These prospects can be for the company itself or its industry. The more growth prospects, the smaller the discount for lack of marketability will be.
- **Integrity of Controlling Shareholder** - The integrity of the controlling shareholder can make a significant difference in the ability to sell a minority interest. If the controlling shareholder tends to deal with the other shareholders honestly and with integrity, minority interests tend to be more marketable.
- **Buy-Sell Agreements** - Buy-sell agreements can result in a higher or lower discount, depending on the terms of the agreement. The agreement can create a market for the stock and make it more marketable, or put restrictions on the sale and make the stock less marketable.
- **Level of Risk** - Studies show that companies with stable earnings tend to have lower marketability discounts, while earnings volatility creates larger discounts.

Summary

- The average discount for lack of marketability is 35%.
- The largest factor influencing the discount for lack of marketability is the existence of a put option. A put option can almost eliminate a discount for lack of marketability.
- A discount for lack of marketability cannot be completely eliminated, as there will always be some factor reducing the marketability of a minority interest.

4.2 Discount for Lack of Control

“A lack of control discount is a reduction in the control value of the appraisal subject that is intended to reflect the fact that a minority stockholder cannot control the daily activities or policy decisions of an enterprise, leading to a reduction in value.”²

Factors Influencing the Discount for Lack of Control

As with the discount for lack of marketability, an individual gifting a company wants to reduce the discount for lack of control. By doing so, the value of the interest in the company being gifted will increase and, consequently, so will the tax deduction. The following factors influence the discount for lack of control:

- **Control Prerogatives** - By providing a minority interest with some of the control prerogatives shown below, the discount for lack of control will be reduced. Some examples include:
 - The ability to select and decide on levels of compensation for officers, directors and employees
 - The ability to decide with whom to do business and enter into binding contracts
 - The ability to decide whether to pay dividends and, if so, how much they should be
 - The ability to register stock with the Securities and Exchange Commission for a public offering
 - The ability to repurchase outstanding stock or issue new shares
 - The ability to make acquisitions or divest subsidiaries or divisions
 - The ability to buy, sell or hypothecate any or all company assets
 - The ability to determine capital expenditures
 - The ability to change the capital structure
 - The ability to amend the articles of incorporation or bylaws
 - The ability to sell a controlling interest in the company with or without participation by minority shareholders
 - The ability to determine policy, including changing the direction of the business
 - Having first rights of refusal
 - The ability to block any of the above
- **Less Than 100%** - Any proportion of ownership less than 100% leaves room for attacks by minority shareholders on some prerogatives of control. The more prerogatives of control that a minority interest has (see list above), the smaller the discount for lack of control will be.
- **Supermajority Requirements** - Even in states that do not have statutory requirements of supermajority votes for major corporate actions, any company may require supermajority votes for certain actions through its articles of incorporation or bylaws. If a block of stock constitutes control for certain actions, but is not large enough to be able to cause supermajority actions, it falls in-between a control value and a minority value. This results in a discount for lack of control, but not as large as the discount a minority interest would have.

² Trugman, Gary. “Understand Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses”. Third Edition. 2008. Pg 409.

- **Swing Vote Potential** - Depending on the distribution of the stock, a block could have the potential to gain a premium price over a pure minority value because of its potential as a swing block. Many scenarios could be constructed where a swing block would have the potential to command some premium over a pure minority value. Thus, if the minority interest could swing an executive decision the minority interest is worth more than it normally would be, reducing the discount for lack of control.
- **Legal or Regulatory Constraints** - Legal or regulatory conditions can prevent a control owner from exercising control prerogatives to the fullest extent. These conditions narrow the gap between control and minority value and reduce the discount for lack of control.
- **Fiduciary Duties** - Sometimes controlling stockholders do not exercise all of the prerogatives of ownership control. This may occur when the controlling stockholder has a fiduciary or other special duty to the minority stockholders. In such cases, controlling stockholders and non-controlling stockholders could be treated equally with regard to economic benefits of equity ownership. In such instances, the lack of control discount is smaller than it otherwise would be.
- **Public Company Characteristic** - Some privately held companies operate very much like publicly owned companies. These characteristics may include: following accounting and legal formalities of public companies, having independent directors on their board, and providing full disclosure to all stockholders. In these instances, the lack of control discount is usually less than it would otherwise be.
- **Dissipated Control** - When there are multiple minority owners, the lack of control discount is often less than it would otherwise be.

Summary

- The average discount for lack of control falls in the 15-30% range.
- Providing control prerogatives to the minority interest may be the best way to reduce the discount for lack of control.