



# VALUATIONS FOR ESTATE AND GIFT PURPOSES

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# OBJECTIVES

- When is a valuation or appraisal required for gift and estate purposes?
- What are the IRS requirements?
- What methods are used to determine value?
- What discounts can be taken?
- What is a subchapter S corporation premium?

## WHEN IS A VALUATION /APPRAISAL REQUIRED

- When filing a gift or estate tax return which includes an asset that does not have a readily available fair market value.
  - Business
  - Real estate
  - Art
  - Jewelry
- If no estate tax return is required, can be done to establish step up in basis at date of death

# GIFT AND ESTATE TAX

- Federal exemption 2018 \$10,000,000 per person
- Minnesota exemption 2018 \$2,400,000 increasing to \$3,000,000 by 2020
- Minnesota Farm and Small Business exemption \$5,000,000
- Annual Federal gift exclusion \$14,000 per person to each recipient
- Minnesota gift tax NONE!
- Federal estate tax rates 18% to 40%

# IRS REQUIREMENTS

- Revenue Ruling 59-60 established initial IRS requirements
  - Nature of Business
  - Economic outlook
  - Financial condition
  - Dividend paying capacity
  - Goodwill
  - Size of the block of ownership
  - Public Market price of stock in similar companies



## IRS REQUIREMENTS CONTINUED...

- Methods that must be considered:
  - Income approach
  - Net asset approach
  - Market approach
- Documentation in a report
- If discounts are involved, rational behind the amount of discount

# MARKETABILITY DISCOUNT

The discount for lack of marketability/liquidity is typically applied to privately-held businesses to give consideration to the fact that there is no ready market for the investment in the company.

- The ability to convert the interest into cash
- The time necessary to convert the interest into cash
- The cost or expense to do so, and
- The price at conversion



## MARKETABILITY DISCOUNT CONTINUED...

**Valuation Advisors Discount for Lack of Marketability Study October 15, 1986 to May 24, 2018**

<u>Time Before IPO</u>	<u>Median Discount</u>	<u>No. of Transactions</u>
< 3 months	25.0%	878
4 to 6 months	38.7%	1,312
7 to 9 months	52.3%	1,044
10 to 12 months	63.0%	998
< 1 year	43.1%	4,232
1 to 2 years	69.0%	1,836



# MINORITY INTEREST DISCOUNT

The discount for minority interest is also referred to as a discount for lack of control. The discount relates to the inability of a minority shareholder to affect management policy. Decisions made by the controlling shareholder, such as dividend policy, investment objectives, compensation, personnel, capital expenditures and operating and marketing strategies, affect the value of the shares.



## MINORITY INTEREST DISCOUNT CONTINUED...

- Minority interest discounts are derived from control premiums paid by an acquirer.
- Mergerstat Review January 2010 to December 2018 Data
  - 4,216 transactions
  - Average Premium over market 27.2%
  - Implied Minority discount 21.4%

# WHAT TO EXPECT FOR DISCOUNTS

- Marketability Discount
    - 5 to 10% for controlling interest
    - 15 to 30% for non controlling
  - Minority interest
    - 10 to 25%
  - Discounts are applied in sequence
    - First marketability then minority
      - Example:* Value before discounts
      - Marketability discount 20%
    - Minority discount 25%
- Discounted value



\$1,000	
<u>(200)</u>	
800	
<u>(200)</u>	
<u>\$ 600</u>	(40% total)

## SUBCHAPTER S CORPORATION PREMIUM

**Theory:** S corporation has only one level of tax. C corporation has corporate tax plus shareholder pays tax on dividends received...**DOUBLE TAXATION!**

Therefore cash flow from an S Corporation is **worth more** than from a C corporation

## SUBCHAPTER S CORPORATION PREMIUM CONTINUED...

		<u>C-Corporation</u>	<u>S-Corporation</u>
Pre-tax income		\$ 7,219,379	\$ 7,219,379
Corporate tax rate (21% + 9.8%)	30.80%	<u>2,223,569</u>	
Net income available to shareholders		<u>\$ 4,995,810</u>	<u>\$ 7,219,379</u>
Dividends (30% of net income)		\$ 1,498,743	\$ 4,204,566
Taxable income after 20% deduction			5,775,503
Personal tax rate (37% + 9.85%)	29.85%	<u>447,375</u>	46.85% <u>2,705,823</u>
Net cash flow to shareholder		<u>\$ 1,051,368</u>	<u>\$ 1,498,743</u>
Benefit to being an S-corporation			<u>\$ 447,375</u>

# SEEMS COMPLICATED...IT IS!

- **Why do we need to go through this?**
  - For Gifts, Statute of limitations 3 years no return filed, no statute of limitation
  - Penalties for understatement
  - Lack of documentation to support values, statute does not run.
  - Valuation supports step up in basis for estate transfers. It's a new starting point for determining capital gains.
  - Transfer assets that are likely to appreciate out of your estate

Q & A

# CONTACT DETAILS



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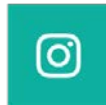
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