Value Matters™

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MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Navigating the Estate Tax Horizon

The Time Is Now

Looking for a **golden opportunity?** A series of articles from the *Wall Street Journal* suggests that one exists, but time is of the essence. There is an urgency to consider a range of estate tax strategy options in order to maximize gifting family wealth rather than **family drama**.

The options range from straightforward gifts to heirs, accelerated gifting, use of irrevocable trusts, and other estate freeze tactics to lock in assets at current value and transfer future appreciation to heirs without triggering additional taxes. This series provides better and more creative ways to plan and divide family assets that can avoid family squabbles over Grandpa's signed **Babe Ruth** baseball or Pawpaw's **1961 Ferrari 250 GT California Spyder.**

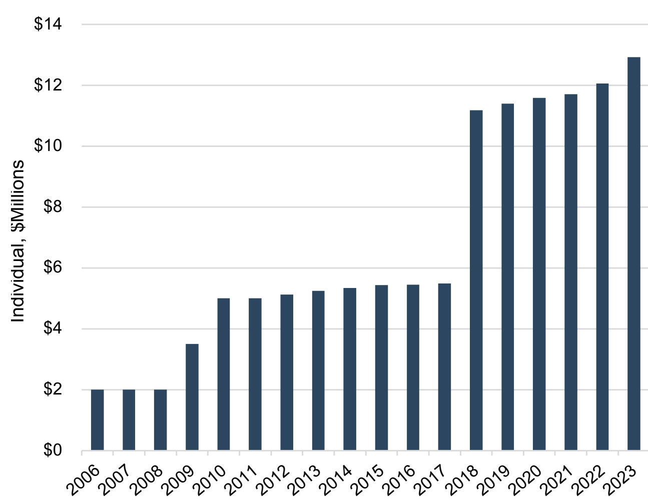
The Estate Tax

In the realm of fiscal policy and wealth transfer, few subjects are as controversial as estate taxes. One side coins the practice a "death tax," unfairly taxing people on their exit from the world and ascension to the pearly gates. The other sees the current estate tax regime as a crucial element of tax policy, redistributing wealth and ensuring an equitable distribution of society's resources.

Since being enacted over 100 years ago, estate taxes have been levied at varying percentages and provided for wide-ranging exemption amounts to taxpayers.

In more recent times, the trend has moved toward larger and larger exemptions, with a significant step-up in the applicable exemptions occurring during President Obama and Trump's respective tenures, figuring into the complicated political calculus on the issue. Figure 1 highlights the federal estate and gift tax exemption for an individual filer in more recent periods.

Figure 1 :: Federal Estate and Gift Tax Exemption



Sunsetting provisions are time-limited conditions that set an expiration date for a particular statute or regulation. These provisions are designed to encourage periodic review of the law's relevance, necessity, and effectiveness.

Current Basic Exclusion Amount to Sunset in 2026

The *Tax Cuts & Jobs Act* of 2017 ("TCJA") doubled the basic exclusion amount individuals could give away without paying estate taxes for tax years 2018 through 2025. For 2023, the combined gift & estate tax exemption is $12.92 million per individual or $25.84 million per married couple.

In 2026, the basic exclusion amount is due to sunset to its pre-TCJA level of $5 million, as adjusted for inflation.

In the context of estate taxes, sunsetting provisions will significantly increase potential estate tax liabilities and motivate wealthy taxpayers to re-evaluate their inheritance planning strategies.

Ashlea Ebeling explains that if a couple transfers their full exemption amount — estimated to be $28 million by 2025 before the law's sunset — they will generate $5.6 million in tax savings. If they make gifts to grandchildren, skipping a generation, there would be nearly $9 million in tax savings. These tax savings could be significantly larger over time, as the appreciation is exempt from transfer tax.

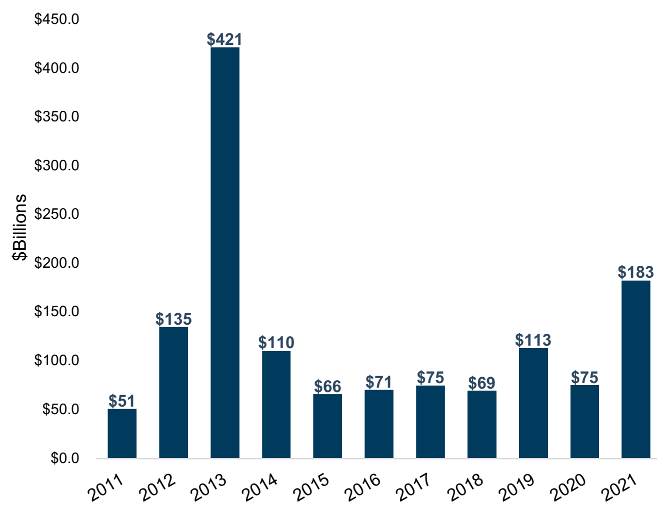
What Does the Past Tell Us?

Figure 2 summarizes total gifts reported to the IRS from 2011 through 2021. Notice anything? The gifts made in 2013 were ~$421 billion — more than double those made in 2021. What happened in 2013? This was the last time there was serious doubt about the future of the gift & estate tax exemption.

With the TCJA sunsetting provisions looming in 2026, a spike in estate planning transactions comparable to that seen in 2013 is likely to occur through the end of 2025, as the exemption is set to drop by 50% in 2026. Don't wait to call your estate attorney on December 1, 2025.

The limit on annual-tax-free gifts for 2023 is $17,000. These gifts do not count against the larger $12.92 million combined gift & estate tax exemption. **Carolina Mckay,** a senior wealth strategist, stated she has clients who make gifts to such a large pool of relatives — grandchildren, nieces, nephews, and spouses — that they can move hundreds of thousands of dollars out of their estates each year.

Figure 2 :: Total Gifts Reported to the IRS



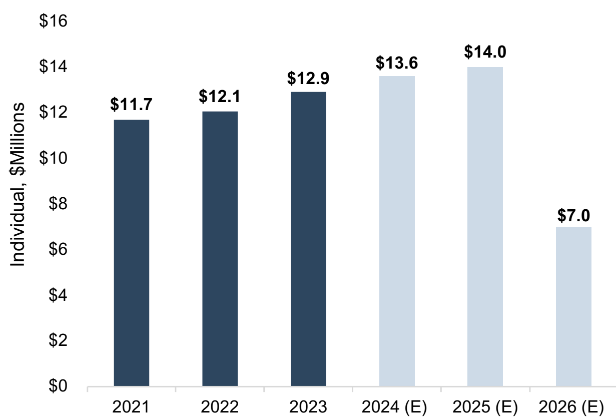
The issue becomes more complicated for long-held stocks that have appreciated in value due to inheriting capital-gains taxes when the stocks are sold. Making gifts to a **dynasty trust** can preserve more wealth as the trust removes the assets from both your estate and your immediate heirs' estates. Such trusts offer asset protection and can also benefit grandchildren and future generations. One thing to note is that these trusts are still subject to capital gains and other income taxes.

What Does the Future Hold?

While it is certainly possible that the higher estate-tax exemption amount could be extended or made permanent, wealthy taxpayers need to weigh the risk of inactivity if the sunset takes place. As one advisor quoted by the *WSJ* noted, "You have to assume the exemption amount is going down."

The extension of the federal estate tax threshold amount will most likely come down to which party holds political power in Congress and the White House in 2026. It is a gamble to bank on the exemption staying at this heightened level in 2026, and you may potentially leave a lot of tax savings on the table.

Figure 3 :: Federal Estate and Gift Tax Exemption
Estimated Through 2026



Estate tax sunsetting provisions add an additional layer of complexity to the already intricate world of estate planning and taxation. While they encourage regular policy review and adaptation, they also introduce uncertainty for taxpayers and can lead to shifts in behavior and financial planning strategies.

Conclusion

As the estate tax landscape evolves, individuals, families, and advisors must stay informed and be prepared for potential changes resulting from sunsetting provisions. Our team of valuation professionals is ready to help you and your clients navigate the resulting valuation challenges.

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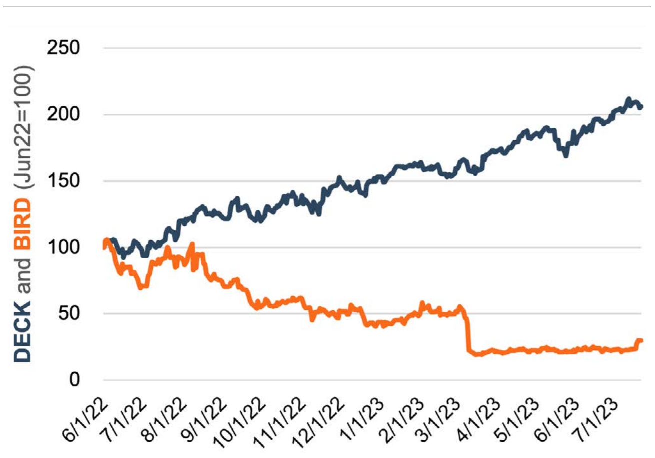
A Tale of Two Shoes

A year or so ago, investors could choose to invest in either of two upstart shoe companies, each of which had successfully taken share from legacy brands. **Allbirds** (ticker: BIRD) had captured consumers' attention by offering comfortable, stylish, environmentally friendly sneakers worn by the likes of former President Obama. On the other hand, fans of the non-traditional Hoka running shoe — described by some as "clown shoes" — could invest in parent company **Deckers Outdoor Corporation** (ticker: DECK).

Both companies reported sales in their most recently ended fiscal years nearly 50% above sales from two years prior. For investors, however, that is where the similarities ended. As illustrated in the following chart, investors selecting Hoka parent DECK have been running circles around those that chose to invest in BIRD.

Figure 1:: Relative Share Prices



We certainly can't claim to have any peculiar foresight in the matter, having invested in neither company at the time. But recently featured articles on **Hoka** and **Allbirds** have caused us to think about lessons that may be available for in the aftermath. Both articles are well worth the read, but we'll distill one primary lesson from each.

Lesson #1 – Don't Underestimate the Value of Scarcity

A recurring theme in the Hoka feature is management's decision not to accept all growth opportunities. When businesses succeed with a product, it is natural to seek wider distribution. While growing distribution points certainly accelerate revenue growth in the near term, it can do so at the expense of long-term sustainability.

Leaning into scarcity as a product attribute doesn't mean managers aren't focused on growth. Rather it means that managers are focused on responsible; and profitable, growth. In the case of Hoka, the *WSJ* article notes that "selective distribution keeps supply below demand and maintains the premium appeal" of sneakers that aren't cheap.

Establishing scarcity as a product attribute is neither intuitive nor easy. It takes conviction and a belief that your product is unique and does address a fundamental consumer need that is not going away. As noted by **Ben Cohen** in the *WSJ* article, "Hoka executives can afford to be judicious because there will always be a market for any product that solves problems and provides value."

For some companies, such confidence would probably be misplaced. Those managers need to seek a different strategy that doesn't rely on scarcity. But cultivating scarcity could be a winning strategy for businesses with a compelling solution to a genuine consumer need.

Lesson #2 – Don't Lose Sight of Your Core Customer

While the Hoka story provides a model for business directors to emulate, the Allbirds story is a cautionary tale. Author **Suzanne Kapner** chronicles the strategic and execution missteps that have diminished the brand's appeal in the market and decimated the company's share price.

While the execution miscues were embarrassing — like selling what were effectively see-through leggings — such fumbles are inevitable; the strategic blunders at Allbirds are more consequential for the long-run sustainability of the company. For better or worse, Allbirds' initial success came from appealing to a fairly narrow set of customers: members of the professional class between the ages of 30 and 50 looking for a comfortable and stylish shoe that, as an added benefit, was positioned as environmentally responsible.

As the company sought additional avenues for growth, it began developing products that did not work especially well for customers who weren't especially inclined to adopt the brand.

- The company's environmental credentials came primarily from relying on Merino wool, which works well in a casual sneaker. However, leggings made from the material aren't quite as opaque as one might hope, and hardcore running shoes made of wool develop holes easily. In other words, whereas Hoka was selling a "product that solves problems and provides value," many of the line extensions at Allbirds turned out to be products that created problems for consumers. Allbirds' value of environmental responsibility was not sufficient to outweigh the performance issues.

- This ***Wall Street Journal, How Allbirds Lost Its Way,*** details the internal confusion regarding the company's core customer. Some company meetings focused on developing new products to appeal to a younger audience desiring edgier designs, workout accessories, and more technical running shoes, while other meetings emphasized comfortable shoes for a modestly older demographic. After Boston Consulting Group completed a consumer study conducted on behalf of the company, management concluded: "that as the company tilted younger, it lost focus on its core."

We've written previously about the **need to maintain a growth** mindset, and cultivating new customers is certainly a path toward growth. However, strategies for attracting new customers that alienate existing customers will prove counterproductive.

What Is the Winning Strategy?

Of course, case studies like those provided by Hoka and Allbirds have limitations. It's possible that by the time another summer rolls around, Hoka will be on the ropes, and Allbirds will have completed a remarkable turnaround. Yet we are convinced that business directors would do well to think about how; and to what extent; the two lessons identified in this post apply to their businesses:

- Is there merit to emphasizing scarcity as a product attribute for your business? Why or why not? If so, what does scarcity look like for your brand/product?

- Does your business have a "core" customer? If so, who is that core customer, and how do you pursue innovation and growth strategies without alienating that customer?

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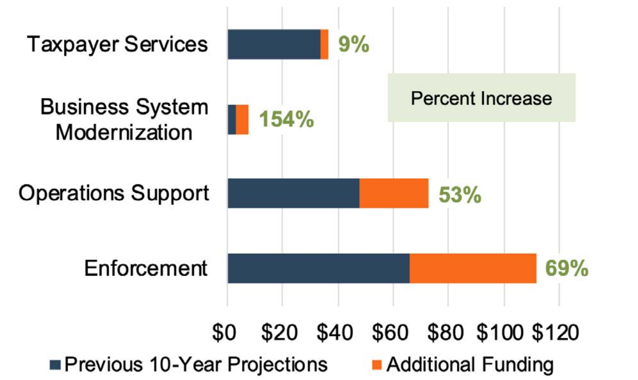
An $80 Billion Estate & Gift Tax Valuation Update

3 Things to Do When Selecting a Business Appraiser

How would you spend $80 billion in new funding? Many articles have been written about the ***Inflation Reduction Act***. One piece of that legislation that will impact every taxpayer is an increase to the IRS of roughly $80 billion over the next ten years. The **Tax Foundation** analyzed how the IRS plans to deploy additional funding, as shown in Figure 1.

Figure 1 :: IRS Funding Increases per *Inflation Reduction Act*



Source: Tax Foundation - https://taxfoundation.org/blog/irs-funding-plan-inflation-reduction-act/ and https://taxfoundation.org/blog/inflation-reduction-act-irs-funding/

One quickly notices "Enforcement" getting the largest dollar increase over the next ten years at nearly $46 billion. The IRS lists **five objectives** in its 2023 strategic operations plan. One of the objectives includes: "Focus expanded enforcement on taxpayers with complex tax filings and high-dollar noncompliance to address the tax gap." Again, from the Tax Foundation:

"Digging more into the specifics of enforcement, individual initiatives acknowledge some of the trade-offs in expanded enforcement operations. Within the third objective, dedicated to expanded enforcement, five of the seven initiatives involve expanded enforcement on certain types of taxpayers: large corporations, large partnerships, high-income and high-wealth individuals, other areas where IRS audit coverage has declined (including employment, excise, and estate and gift taxpayers), and developing areas such as digital assets."

A recent presentation by **Stephanie Loomis-Price** and **Marissa Pepe Turrell** at the ASA's International Conference summarized 709 (gift) and 706 (estate) filings and audit rates, excerpted in Figure 2 below.

(Table Continued on the next page)

Figure 2 :: Gift and Estate Tax Filings and Audit Rates

Year	Tax Collected ($Billions)	709s Filed	709s Closed/ Examined	% Examined	Recommended Add'l Tax After Exam ($Billions)
2022	$4.4	270,142	904	0.3%	$0.8
2021	$4.6	282,054	1,187	0.8%	$0.5
2020	$1.1	158,095	1,259	0.5%	$0.3
2019	$1.6	239,618	1,839	0.8%	$0.3
2018	$1.2	244,570	2,090	0.9%	$0.5
2017	$1.9	242,426	1,886	0.8%	$0.4
2016	$2.5	249,302	1,843	0.8%	$0.3
2015	$2.1	238,324	2,539	0.9%	$0.3
2014	$2.6	267,600	3,098	0.8%	$1.3
2013	$5.8	371,747	2,775	1.1%	$1.2

Total gift tax audits have been just under 1% for the last

Figure 2 (continued) :: Gift and Estate Tax Filings and Audit Rates

Year	Tax Collected ($Billions)	706s Filed	706s Closed/ Examined	% Examined	Recommended Add'l Tax After Exam ($Billions)
2022	$28.9	27,088	1,398	4.9%	$1.8
2021	$23.4	28,473	1,635	10.9%	$1.3
2020	$17.1	15,023	1,454	5.6%	$0.4
2019	$16.0	25,742	2,282	6.9%	$0.5
2018	$22.7	32,847	2,898	8.6%	$1.5
2017	$21.8	33,690	2,876	8.2%	$0.8
2016	$19.9	35,042	3,187	8.8%	$0.8
2015	$18.0	36,130	2,770	7.8%	$0.4
2014	$17.6	35,619	2,853	8.5%	$0.8
2013	$14.1	33,719	3,250	11.6%	$3.3

Source: ASA International Conference, Stephanie Loomis-Price and Marissa Pepe Turrell Presentation October 2023

decade, and estate tax audits have been around 10% on average, per Figure 2. And while audit rates have remained stable overall for gift and estate tax filings, one doesn't have to connect too many dots to see that may be changing. Much has been written on **declining audit rates**, and policymakers have explicitly said they plan to **audit wealthier Americans.** So, with plenty of dry powder to beef up enforcement and looming changes to the **estate tax horizon** (including a reduction in the estate and gift tax exemption), businesses and estate planners need to be cognizant of the changing tax landscape and increased audit scrutiny.

3 Things You Should Do When Selecting a Business Appraiser

How do business appraisers fit into this shifting gift and estate tax paradigm? If your gift tax return involves a business valuation, having a trusted and reputable valuation firm as part of your estate planning roster is more important than ever. Below are three criteria that can help you think about who you want in your corner.

1. **Insist on an appraiser with experience and credentials.** Each business appraisal is unique, and experience counts. Most business valuation firms are generalists rather than industry specialists, but the experience gained in discussing operating results and industry constraints with a broad client base gives the appraisal firm substantial ability to understand the client's specific situation. Credentials do not guarantee performance, but they do indicate a level of professionalism for having achieved and maintained them. Businesses and their estate planning counsel should insist upon them.

2. **Involve the appraiser early on.** One of the most common concerns such owners cite around long-term planning is the ability to transfer ownership of the business in the most tax-efficient way. Even in seemingly straightforward **gift and estate tax planning,** it is helpful to seek the advice of a business appraiser as part of the planning process. Understanding the finer points around fair market value, the levels of value, discounts for lack of marketability, and ultimately estimated tax liabilities are all questions a business appraiser should be able to provide feedback and guidance upon.

3. **Expect the best.** In most cases, the fee for appraisal services is nominal compared to the dollars at risk. The marginal cost of getting the best is negligible. Senior management can help their appraiser do the best job possible by ensuring full disclosure and expecting an independent opinion of value. The best appraisers have the experience and credentials described above but recognize the delicate balance between the inherent art and science when valuing private companies.

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Fall 2023 M&A Update

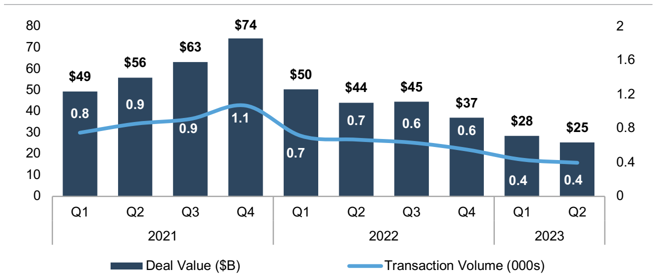
Middle-market transaction activity fell in the second quarter of 2023, continuing an ongoing decline in transaction activity in the middle market. The decline was seen across the entire market; as activity by both strategic and financial buyers declined in the quarter. Pricing multiples, which had shown resiliency in recent quarters, declined with overall deal activity; hampered by further interest rate increases and general economic uncertainty in the second quarter.

Deal multiples across all size tranches fell in the second quarter of 2023, as reported by *GF Data*. They reported the number of private equity deals fell from 78 deals in the first quarter of 2023 to 57 deals in the second quarter, which is also down from 76 reported deals in the second quarter of 2022. Average multiples on all completed deals fell from 7.7x EBITDA in the first quarter of 2023 to 6.4x, the lowest reported average multiple since Q3 2020. The 6.4x average multiple in the second quarter is also down a full turn from the 7.4x average multiple reported by *GF Data* a year ago. Deal volume for both strategic and financial deals presents a similar picture.

The chart on the right highlights overall deal value and volume, including strategic deals. The second quarter of 2023 represents the lowest levels of value and volume across the period analyzed.

While the state of the middle market, when viewed through the lens of deal activity in the second quarter, appears bleak, deals still have gotten done in the first half of 2023; albeit under rapidly evolving macroeconomic and market conditions. The Federal Reserve continued to raise interest rates in the second quarter of 2023 to fight persistent inflation in the U.S. economy. U.S. equity markets posted broad gains in the second quarter while ongoing geopolitical tensions continued to percolate and unemployment in the U.S. remained historically low.

U.S. Deal Value and Volume | Q1 2021 to Q2 2023



Source: Capital IQ

All that to say, the current macroeconomic environment appears to be teeming with contradictions and uncertainty, making planning and forecasting extremely difficult for companies. One potential aspect of this process — pursuing an acquisition or developing a corporate M&A strategy — becomes more precarious than usual in uncertain economic conditions.

Headlined by rising interest rates, we suspect that uncertainty of the U.S. economy's future played an outsized role in the second quarter's depressed middle market deal activity. It is also important to note that M&A deals do not get done in a single day, month, or typically even quarter. There is a lag between the deal agreement (letter of intent negotiation) and the transaction closing. The reduced number of closed deals and lower multiples of the second quarter partly reflect reduced market activity in the first quarter of 2023. While there has been no relief on the interest rate front, general economic sentiment appears to have improved as 2023 has progressed, alongside diminishing expectations of an imminent recession.

Despite these current challenges, quality businesses coming to market are still commanding multiples that have the potential to get deals done. There will always be a market for companies that can generate growth, have steady and predictable cash flows and margins, and achieve scale in their industry. Private equity investors still have large amounts of "dry powder" on hand and continue actively seeking returns in many areas of the available investment universe, including the middle market.

Business owners looking to sell their business in the current environment will have to be prepared for the transaction process, given heightened levels of diligence and scrutiny from potential buyers and their lenders. User-friendly financial statements, well-crafted offering materials, and a deep knowledge of the value drivers in your business and industry are now more important than ever.

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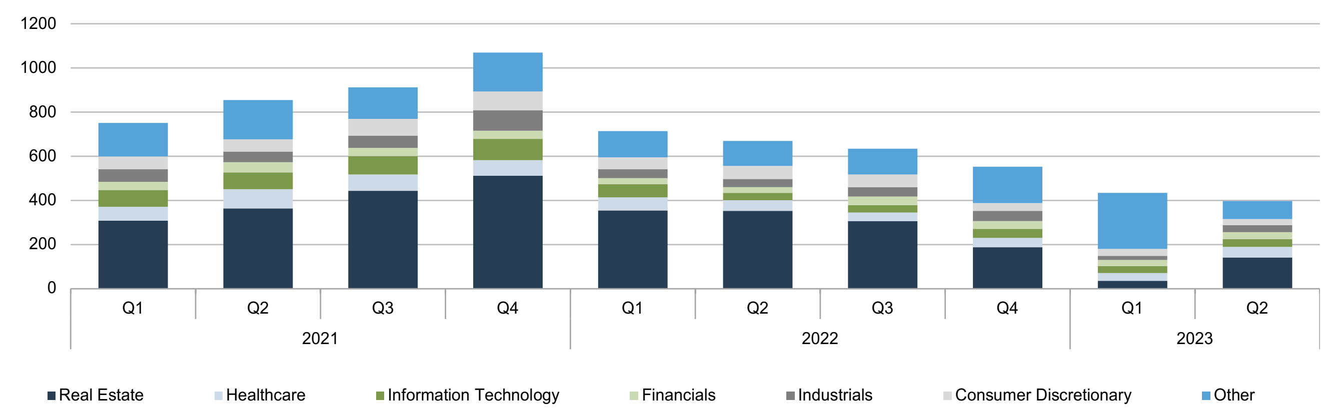
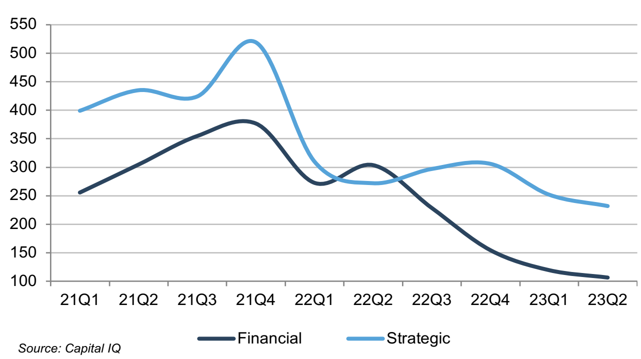
M&A Charts of Note

U.S. Deal Volume by Industry | Q1 2021 - Q2 2023



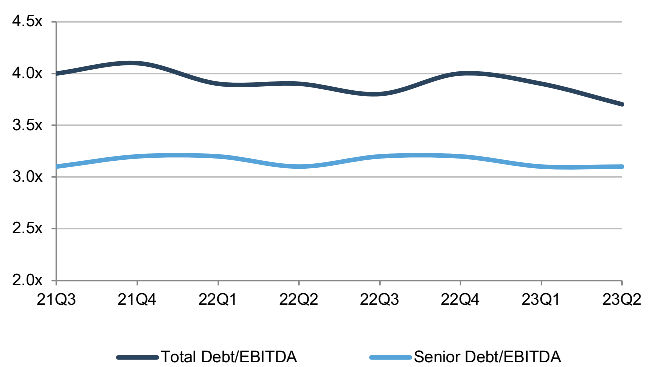
Source: Capital IQ

Number of Deals by Buyer Type | Q1 2021 - Q2 2023



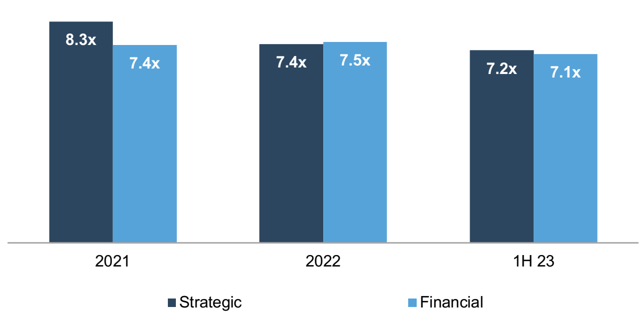
Source: Capital IQ

Debt Multiples | Financial Buyers | Through 2Q 2023



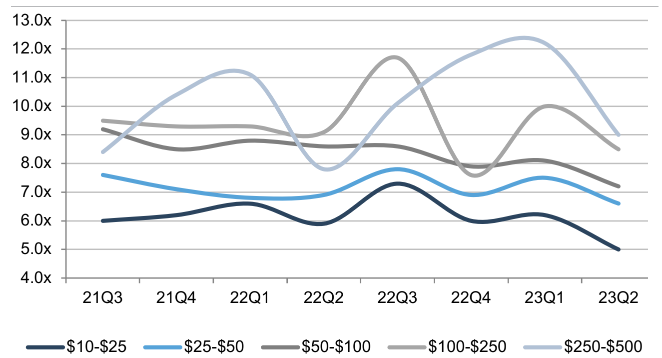
Source: GF Data®

EBITDA Multiples by Buyer Type | 2021 to 1H 2023



Source: Capital IQ (strategic) and GF Data (financial)
Strategic multiples exclude outliers (defined as EBITDA multiple > 18x)

TEV/EBITDA Multiples | Financial Buyers | Last 8 Quarters



Source: GF Data®

Mercer Capital

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Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, solvency opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

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