

VALUE MATTERS®

Gift, Estate, & Income Tax Valuation Insights Newsletter

The Elements of a Quality Business Valuation

A Guide for Estate Planners

Authored by Timothy K. Bronza, CPA, ASA

In the course of a business valuation practice, a business appraiser may either be involved in an examination of an opinion that they have issued or serve as a consulting expert to assist legal counsel in an opinion issued by an unaffiliated business appraiser.

While an accepted-as-filed resolution of an independent and objective opinion of value for a federal tax matter is the desired outcome, an IRS examination also provides an opportunity for appraisers to critically evaluate their work, and, in so doing, strengthen future work product.

As Mercer Capital is frequently requested to provide expert consulting services related to federal tax valuation matters under examination, this issue of *Value Matters*® explores the elements of a quality valuation that increase the prospects of a favorable resolution of an examined matter, or the desired accepted-as-filed outcome at an initial reporting stage.

Elements of a Quality Valuation

Quality business valuations possess four common elements:

1. Identification of the rights and benefits of the business interest being valued;
2. Relevant and sufficient capital market evidence;
3. Sound financial analysis; and,
4. Effective reporting to the intended audience.

Identification of the Rights & Benefits of the Business Interest

Fundamental to any sound valuation is a thorough understanding of the rights and benefits of the business interest being valued.

Most often this involves a close review of the basic governance documents of the business such as corporate articles of incorporation and bylaws, partnership or limited liability operating agreements, buy/sell agreements, and additional legal documents that address the rights and benefits of the subject business interest. Absent formal governance documents, relevant statutory provisions in the entity's state of domicile provide this guidance. This guidance directs the appraiser as to the appropriate level of value for the assignment, i.e., controlling interest, minority interest or veto block interest.

While it is not the role of the business appraiser to be the ultimate arbiter of the legal rights and benefits related to the interest, it is the responsibility of the appraiser to have as complete an understanding as they can of these defining attributes. In cases of ambiguous governance documents or situations of default to statutory provisions, assistance from legal counsel is warranted to provide legal direction as to the attributes of an interest.

Once a complete understanding of the legal rights and benefits of the interest is gained, it is critical for the business appraiser to keep this understanding at hand throughout the appraisal process and report on this understanding in a concise and clear manner.

Relevant and Sufficient Capital Market Evidence

A cornerstone of every sound opinion of value resides in the capital market evidence that is relied upon for its support. Relevancy and sufficiency are two essential concepts for consideration in evaluating capital market evidence.

Relevance

The relevance of capital market evidence is a key component of the valuation of interests in privately held businesses, as often there is a dearth of pertinent capital market evidence related to the interest being valued. This reality illustrates the inherent challenge associated with the valuation of privately held business interests; by definition financial and transactional information related to private businesses is most often not in the public domain. As a consequence, business appraisers frequently look to capital market evidence related to publicly traded businesses to find the capital market evidence necessary to support their opinion. Material differences between the subject business interest and the capital market evidence relied upon must be reconciled and explained.

Sufficiency

Sufficiency is the second core concept related to capital market evidence. The time-tested adage that “one sale does not make a market” certainly applies.

Often, the business appraiser is faced with a scenario of capital market evidence of limited quantity. In such instances the appraiser should expand search parameters in order to obtain capital market evidence with similar investment risk attributes as the subject interest.

A default to the opinion based on the personal experience of the appraiser without sufficient market evidence will be subject to intensive scrutiny, and quite likely, may be considered a failure of the opinion for its intended use.

Sound Financial Analysis

Thorough and sound financial analysis is crucial to any supportable valuation. The fundamental valuation principle is that the value of a business is a function of three components: (1) expected cash flows, (2) risk profile, and (3) growth prospects.

Expected Cash Flows

Identifying and estimating the expected cash flows of a business requires careful consideration of historical financial results, anticipated economic and industry conditions, and the capital needs of the business (a more exhaustive list of data and factors that should be considered is included in IRS Revenue Ruling 59-60).

Risk

An evaluation of the risk profile of a business cannot be done without understanding the key drivers of the business. A business is subject to and impacted by a litany of factors including market risks, operational risks, and financial risks that must be evaluated.

Growth

An appraiser's assessment of growth prospects should consider growth due to market share, growth of the market, growth from profitability, and the sustainability of each.

Business appraisers should conduct robust financial analyses and due diligence to evaluate these three components, and quality appraisals will provide sound and reasonable support for the concluded estimates of each.

Effective Reporting to the Intended Audience

The most important aspect of the valuation may well be how effectively the appraiser communicates to the intended audience of the valuation report.

For federal transfer tax valuation matters, the intended audience consists of estate planning and tax attorneys as well as Internal Revenue Service trust & estate examining attorneys.

For federal income tax matters the intended audience consists of tax attorneys, certified public accountants, enrolled agents and Internal Revenue Service agents, typically individuals with an accounting and tax background.

As the readers of a valuation report may be more verbally rather than numerically oriented, a valuation report prepared for a transfer tax matter should be written in a communication style and structure that matches this orientation. In contrast, it may be more appropriate for reports prepared for income tax matters to have a quantitative tilt.

Conclusion

While the examination of a federal tax valuation matter can be a challenging exercise laden with complexity, past examination experience also provides opportunities to focus on the fundamentals of the valuation process that underlie a quality valuation.

Adherence to the concepts presented in this article will improve the likelihood of accepted-as-filed outcomes as well as place the valuation work product in a position of strength in the event of an examination.

At Mercer Capital, we diligently incorporate each of the four elements of quality valuations into our reports. To discuss your valuation need on a confidential basis, please contact one of our professionals.

WE WILL BE ATTENDING

HECKERLING 2025



Tim Bronza
tim.bronza@mercercapital.com



Travis Harms
harmst@mercercapital.com



Matt Crow
crowm@mercercapital.com



Tim Lee
leet@mercercapital.com



Mercer Capital is attending the upcoming 59th Annual Heckerling Institute on Estate Planning, January 13-17, 2025 at the Orlando World Center Marriott. Are you? If so, feel free to reach out to us so we can get together at the event.

Other Upcoming Events

CONFERENCE SPONSORSHIP

12th Annual Florida Tax Institute

February 5 - 7, 2025 | JW Marriott Tampa Water Street

- Timothy K. Bronza, CPA, ASA
- Barbara Walters Price

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ACTEC 2025 Annual Meeting

March 19 - 23, 2025 | La Quinta Resort & Club, Palm Springs, CA

- Timothy K. Bronza, CPA, ASA
- Matthew R. Crow, CFA, ASA
- Travis W. Harms, CFA, CPA/ABV

Valuations are a critical element of successful tax planning strategies and objective third party valuation opinions are vital.

Business valuations prepared for federal tax transactions are at the core of Mercer Capital's valuation practice. Since 1982, we have been providing objective valuations for federal estate, gift, income tax, and corporate transactional matters. We are recognized experts in this challenging area of valuation practice.

Mercer Capital is one of the largest independent business valuation and transaction advisory firms in the nation, with a deep bench of seasoned professionals. We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. With the size of our staff and the firm's technical and project management expertise, we can handle projects of any size, no matter how complex.

And we understand what the IRS considers important. From corporate income tax planning to transfer tax planning and administration, a federal tax valuation plays a central role in positioning your or your client's business for success. That is why we take great care to ensure our federal tax valuations are substantiated and well-documented, enabling you to implement effective planning strategies with confidence.

Gift, Estate, and Income Tax Valuation Services

Estate and Gift Tax Transactions

- Estate Tax Administration and Reporting – IRC §2031
- Estate & Gift Tax Controversies – Valuation Consulting
- Gift Tax Planning & Reporting – IRC §2512
- Pre-Expatriation Planning & Reporting

Income Tax Transactions

- Allocation of Value, Determination of Professional Goodwill
- Charitable Contributions – Reg. §1.170A – 13(c)(2)
- Compensation in Kind – Reg. §1.61-2(d)(1)
- Compensation Planning – IRC §§83(b) and 409(A)
- Corporate Reorganizations
- Corporation to S Corporation Conversion – IRC §1374
- Divestitures
- Expatriation Tax Reporting – IRC §877A
- Income Tax Controversies – Valuation Consulting
- Net Operating Loss (NOL) Carryforwards – IRC §382
- Not-For-Profit – IRC §501(c)(3)
- Qualified Stock Purchases IRC §§351, 352 and 338
- Worthless Securities – IRC §165

Contact Us



Timothy K. Bronza, CPA, ASA
 tim.bronza@mercercapital.com
 407.599.2825



Bryce Erickson, ASA, MRICS
 ericksonb@mercercapital.com
 214.468.8411



Travis W. Harms, CFA, CPA/ABV
 harmst@mercercapital.com
 901.322.9760



J. David Smith, ASA, CFA
 smithd@mercercapital.com
 832.432.1011