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Valuing a Business for Estate Planning Purposes During a Transaction

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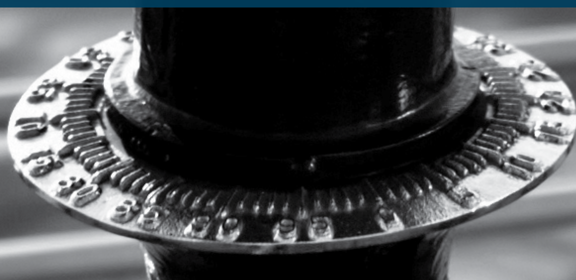
About This Whitepaper

This whitepaper discusses several items we consider when appraising a business for estate planning purposes while a transaction process is underway. We review IRS commentary on consideration of potential transactions in business appraisals for transfer tax purposes. We then provide an overview of the various stages of an M&A process and discuss valuation considerations across each stage. We then review market evidence for success rates of announced deals, and several other factors that should be considered when determining the extent to which the expected proceeds from a potential deal should be considered. We finish with a discussion of the economics of deal proceeds.

Since a business often represents the majority of an owner's wealth, it is common for owners to consider both exiting the business and engaging in estate planning at the same time.

There are several common estate planning strategies that are useful in a situation when a business transaction process may already be underway. Having a valuation specialist who is knowledgeable of both 1) IRS guidance around transferring ownership in a closely held business when a transaction process is underway, and 2) the proper use of market data to support a valuation opinion is imperative to avoid unintended consequences.



What Is the Position of the IRS?

Chief Counsel Advice 202152018 ("CCA 202152018") was issued December 30, 2021 by the IRS Office of Chief Counsel. This commentary provides insight into the IRS's position on whether appraisers should consider a potential business transaction when valuing business interests for tax transfer purposes. The short answer is yes–potential transactions should be taken into consideration when valuing a business interest given that the intent and actions taken to begin a transaction process were knowable on the transaction or valuation date. How exactly to do that requires some explanation.

Chief Counsel Advice Memorandums Explained

What is a Chief Counsel Advice memorandum? A CCA occurs in response to a field level IRS employee asking for guidance on an issue or topic. The Office of the Chief Counsel of the IRS will issue a CCA to communicate legal interpretations of IRS or Office of Chief Counsel positions or legal interpretations of state law, foreign law or federal law relating to tax collection.

Timeline of Events That Led to CCA 202152018

The case that led to the issuance of CCA 202152018 involved a founder of a successful company ("the Donor") who transferred shares of his company ("Subject Company") to a two-year Grantor Retained Annuity Trust ("GRAT") and to a Charitable Remainder Trust ("CRT") during a sales process and used two different valuations. The timeline, which occurred over a period of four calendar years, is detailed below based on the CCA 202152018 memorandum.

The Donor contacted two investment advisors to explore the possibility of selling the Subject Company around the end of the first year. The Subject Company was marketed through outreach by investment bankers to potential strategic buyers, some of whom had previously expressed interest in partnering with the Subject Company. Meetings were scheduled to introduce the potential buyers to the Donor and Subject Company and gauge if there was further interest. The potential buyers were expected to purchase a non-controlling interest in the Subject Company with a call option after several years to acquire the remainder of the Subject Company at a formula valuation.

Two valuations, one transaction timeline—CCA 202152018 underscores why consistency and timing matter.

Approximately six months later, in the middle of calendar year two, the investment advisors presented the Donor with offers from five potential buyers.

Three days after the offers were presented, the Donor created a two-year GRAT. Under the terms of the GRAT, the trustee was to base the amount of the annuity payment on a fixed percentage of the initial fair market value of the trust property. The Donor funded the GRAT with shares of the Subject Company at a value of $x per share, basing the value of the shares on an appraisal of the Subject Company as of December 31st of the first year, which was approximately seven months prior to the funding of the GRAT. Additionally, the appraisal of the shares was done for the purpose of satisfying the reporting requirements for non-qualified deferred compensation plans (409A).

Additional time was given for the five bidders to submit final offers. Four of the five bidders raised their offers, with the fifth withdrawing from bidding. The four final offers were received within approximately three months of the initial offers.

One month later, which was approximately ten months into the second year, the Donor transferred Subject Company shares into a CRT. Approximately one month after the transfer of shares to the CRT, the Donor accepted one of the offers which was for nearly 3x the original per share value. The CRT was funded with Subject Company shares based on a qualified appraisal of the shares at the final offer price. The Donor and his CRT both sold shares as part of the transaction at the final offer price.

On December 31st of year two, the Donor had the Subject Company appraised again for 409A purposes at a value of nearly $2x per share. At December 31st of year three, the shares were appraised yet again for 409A purposes at a similar value as the nearly $2x per share from the end of year two. The 409A appraisals at the end of years two and three both used the following language: "according to management, there have been no other recent offers or closed transactions in Company shares as of the Valuation Date." The 409A appraisal at the end of year one did not have that language.

In year four, approximately six months after the end of the two-year GRAT term, the winning bidder purchased the remainder of the Subject Company's shares at a price of almost four times the original valuation used to fund the GRAT.

A complete timeline is summarized in Figure 1.

Figure 1

Timeline	Action	Approximate Appraised Value
T-0 (end of Year 1)	409A Appraisal Investment advisors hired and marketing process begins	$x
T-0 plus 6 months	Donor presented with five initial offers	
T-0 plus 6 months and 3 days	Donor funds GRAT using 409A appraisal from end of Year 1	$x
T-0 plus 9 months	Four of five offers raised	
T-0 plus 10 months	Donor gifted shares to CRT using qualified appraisal	$3x
T-0 plus 11 months	Donor accepted one of the offers for a portion of the shares	$3x
T-0 plus 12 months	409A Appraisal	$2x
T-0 plus 24 months	409A Appraisal	$2x
T-0 plus 30 months	Remainder of Subject Interest Company shares purchased	$4x

Issues Addressed in CCA 202152018

CCA 202152018 was written in response to two issues related to the case.

- The first issue was whether hypothetical willing buyers and sellers of shares in the Subject Company would have considered the transaction process for purposes of determining the value of the shares for transfer tax purposes. The initial offers made in the middle of year two were at prices well above the $x per share valuation from the 409A appraisal at the end of year one.

  Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts per Treasury Regulation §25.2512-1. As of the date of the GRAT funding, a hypothetical willing buyer of shares in the Subject Company could have reasonably foreseen the merger given there were five initial offers to purchase the Subject Company. The accepted final offer of approximately $3x per share represented a ten percent increase over that bidder's initial offer. The initial offer from the winning bidder and the other four offers, which were all well above the $x appraised value from the 409A appraisal at the end of year one, was known as of the date of funding of the GRAT. Therefore, the $x per share value that was used for funding the GRAT did not consider material facts that were knowable as of the transfer date and was not a fair representation of the Subject Company's fair market value as of the transfer date.

> ***Fair market value requires consideration of all reasonably knowable facts at the valuation date—even those pointing to a pending sale.***

- The second issue was whether the Donor retained a qualified annuity interest when the Donor used an appraisal that did not consider all the knowable facts at the valuation or transfer date. The CCA position was that the retained interest by the Donor was not a qualified annuity interest under Section 2702 of the IRS Code because the appraisal used for valuation of the Subject Company shares was seven months old and did not take into consideration the potential transaction of the Subject Company.

Key Takeaways from CCA 202152018

The key takeaways from CCA 202152018 are:

- An appraisal for a GRAT, or any transfer tax purpose, should ideally be done using a valuation date that matches the transfer date and considers all knowable facts on that date including potential transactions.
- Appraisals prepared for purposes other than the transfer (in this case a 409A appraisal) may not capture the appropriate fair market value standard.
- Valuations for charitable contributions and other transfer tax purposes that are close in proximity should be consistent.

In the Subject Company's case, all of these rules were broken.

- An outdated valuation that ignored key facts (the potential transaction) was used for GRAT funding purposes
- The appraisal used for GRAT funding purposes was intended to be used for 409A purposes
- The appraisal used for the CRT was nearly three times higher than the appraisal used for the GRAT, making it appear as if the CRT appraisal was done to obtain a higher tax deduction

Overview of the Stages of an M&A Process and Valuation Considerations

The Transaction Process

Every business transaction process will be unique. However, there are generally six phases of a mergers and acquisitions (M&A) process.

1. The Planning Phase
2. The Marketing Phase
3. The Qualification Phase
4. The Buyer Selection Phase
5. The Due Diligence Phase
6. The Final Negotiations Phase

The Planning Phase. The planning phase involves hiring an M&A advisor and gathering and organizing information needed for the advisor to market the company. This step can be time intensive, particularly for smaller businesses that do not already have detailed documentation of history, financial performance, products or services, processes, strategies, and other important aspects of the business. The M&A advisor will typically use the information to put together a confidential information memorandum "CIM."

The Marketing Phase. During the marketing phase, the M&A advisor will contact potential buyers with limited information to gauge interest. Interested buyers will sign non-disclosure agreements, receive the CIM, and have the opportunity to discuss additional questions with the advisor.

The Qualification Phase. Interested potential buyers will then make indications of interest ("IOI") to the advisor, which are non-binding, during the qualification phase. The potential buyers will typically provide information about their expected offer range, sources of financing, timeline for due diligence, proposed structure, and post-transaction plans for the business. For the seller, ideally there will be multiple IOIs and a select group of potential buyers with the most attractive IOIs will be picked to meet the selling company management team.

The Buyer Selection Phase. The buyer selection phase includes management presentations to the selected potential buyers so that the buyers and sellers can vet each other. Buyers who remain interested will then submit a letter of intent "LOI," which typically includes a purchase price, closing date, funding details, and the length of exclusivity. The seller will then select one of the buyers who submitted an LOI. The LOI typically establishes a period of exclusivity during which the seller may not engage with other firms while the buyer conducts due diligence. The LOI can still allow either party to back out of the proposed deal. However, both parties are serious and invested in the process at this point, and, as we will discuss later, a deal process that makes it this far is more likely to close.

The Due Diligence Phase. During due diligence, the parties will both bring in additional professional service providers. The buyer will examine the company's financial records, fixed assets, labor force, customers and supplies, and the competitive landscape in more detail. The seller will conduct due diligence on the buyer's ability to close the deal and post-deal plans.

The Final Negotiations Phase. In the final negotiations phase, all deal pricing and structure discrepancies will be resolved and plans will be made to address all stakeholders on the deal closing.

Consideration of the M&A Process in Tax Transfers

The challenge is determining how the business's value may vary at different stages of the M&A process and how that impacts tax transfers for an owner engaged in estate planning. The expected present value of the proceeds from the transaction should be considered as a valuation indication once a transaction process has begun. However, there are differing amounts of information available depending on the stage of the transaction process on the date the transfer is made.

Prior to the business hiring an M&A advisor or any other professional service providers to help with the transaction process, there would likely be no quantifiable expectations for potential proceeds from a transaction. A typical appraisal of the business, which considers income, market, and asset approaches, can be used. If it is clear through the business valuation diligence process that the owners of the business expect to sell the business in the foreseeable future (the next few years), consideration should be given to the discount for lack of marketability (if a minority interest is being appraised). An expected monetization event could reduce the amount of discount that is appropriate, all else being equal.

Once a CIM has been distributed to interested buyers, there is likely some analysis and expectations around the potential selling price for the business. At this stage, valuation for transfer tax purposes considers potential proceeds based on the sale price expectation. Consideration at this stage should also be given to the typical appraisal approaches (in a no-sale scenario) given there are no formal offers yet and the likelihood that there will not be a sale is likely still material.

As the marketing process progresses through various stages, the sellers may receive term sheets, initial indications of interest "IOIs," Letters of Interest "LOIs," and so forth. Offers may go through multiple iterations, and the nature of the consideration offered may also change. As the deal progresses toward a sale, an appraisal of the business will increasingly regard the pricing suggested by the negotiation process. No deal is done until it closes, so until closing occurs, there will be consideration of a failure to sell. In addition, deal terms may include elements of consideration to be paid for the business which must themselves be analyzed to determine cash equivalency.

Fair market value is a cash-equivalent concept. Stock-for-stock consideration may require a valuation of the stock to be received by the sellers, the structure of exchange ratios, the liquidity of the shares received, etc. Contingent consideration requires particular care, as performance-based earn-out payments may not, in fact, be earned by the seller. A transaction which appears to be priced at, say, 12x EBITDA may only be worth 9x on a cash equivalent basis once the time to receive payment and the risks of that payment (or those payments) is adequately considered.

Market Evidence for M&A Deal Success and Failure Rates

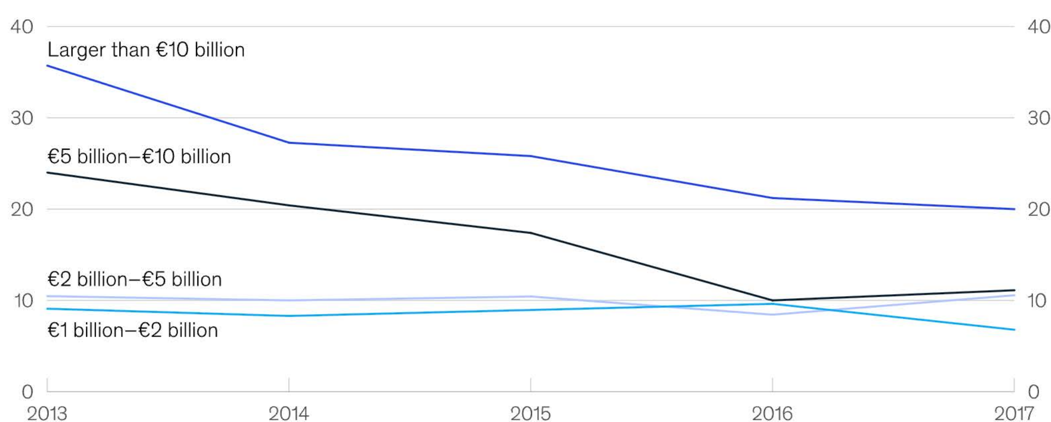
At each stage of the transaction process, the appraisal should consider how much weight should be assigned to the no-sale scenario versus the expected proceeds from a potential transaction? The answer depends on the specifics of the business and transaction process in question, but there are some studies available that examine success and failure rates of business transactions.

In McKinsey & Company's ***"Done deal? Why many large transactions fail to cross the finish line"*** (August 5, 2019), more than 2,500 deals valued at over €1 billion and announced between 2013 and 2017 were examined. Approximately 10.5% of those deals were canceled. Interestingly, the largest deals were more likely to be canceled, with over 20% of deals valued at more than €10 billion being canceled. Deals valued at less than €5 billion had a consistent cancellation rate of around 10% each year examined.

McKinsey's analysis also sorted the deals by industry. Deals in the energy and financial sectors were the least likely to be canceled at a rate of around 7%. Deals in the consumer discretionary and communications services industries were most likely to be canceled (13% and 19%, respectively).

Figure 2

Large M&A deals[1] terminated/canceled, 2013–17,[2] %



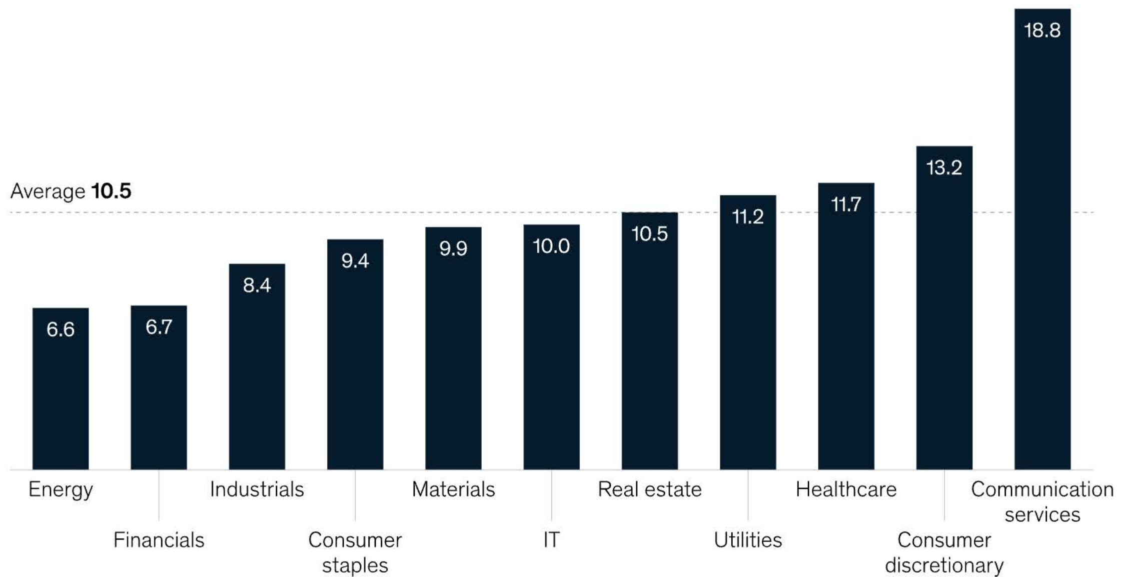
[1]Deals larger than €1 billion.
[2]Data for 2018 have been collected but are not reflected here, as reviews are still pending and deals may still be canceled. Data for 2015 onward may also include transactions that are still pending.
Source: Capital IQ; McKinsey analysis

Lastly, McKinsey noted that nearly 75% of canceled deals (by deal value) were due to price expectations, regulatory concerns, or political concerns.

We note that the deals examined were all publicly announced. Thus, the data on success and failure rates is more relevant for closely held companies that are closer to the end of the deal process when LOIs have been received and a potential buyer has been selected. For closely held companies that are closer to the beginning of the M&A process, there is no market data widely available to examine. Closely held companies that have sent out CIMs to prospective buyers, but then decide to terminate the M&A process, would not disclose publicly that they had a "failed" transaction process. The potential seller could back out of an M&A process for many reasons before getting to the point of receiving IOIs or LOIs. Therefore, a case can be made that significant weight should be given to the no-sale scenario when valuing a business that is in an early stage of the M&A process. Most transaction data suffers from survivorship bias; we know the most about the transactions that actually close.

Figure 3

Large M&A deals[1] cancellation rate by sector, 2013–18, %



[1]Deals larger than €1 billion.
Source: Capital IQ; McKinsey analysis

Factors to Consider in Assessing the Likelihood of M&A Deal Success

Expected Deal Timeline. Generally, the longer the deal takes to close, the higher the likelihood that the deal fails. For cases where a binding agreement is already in place, but the deal has not yet closed, there remains some likelihood that one of the parties could back out. In those cases, the appraised value for the tax transfer should be based on the present value of the expected proceeds, with a discount for lack of liquidity to account for the time until proceeds are received and the likelihood of the deal being broken.

Size of the Deal. McKinsey's analysis shows that smaller deals are more likely to close. However, the data included in the McKinsey study is limited to deals in excess of €1 billion.

Deal Structure Complication. As noted in the McKinsey analysis, all cash and all stock deals were more likely to succeed than mixed-deals, suggesting complexity increases the risk of failure. This may be because shareholders of the selling company must evaluate more variables when deciding how to vote. In cases of a sole owner, deal structure is a less relevant factor to consider as only one shareholder makes the decision. This factor also includes other pieces of the deal structure, such as earn-outs. Deals where proceeds are not fully received upon closing may be more likely to fail compared to deals where all proceeds are received immediately upon closing.

Even with a binding agreement, the deal isn't done — structure, bidders, timing, and so much more matter.

Number of Bidders. Interest from multiple potential buyers likely increases the chances of a successful deal closing. A larger pool of interested bidders provides more fallback options, ensuring the deal can still move forward even if the initially selected buyer backs out. However, this factor could also cut the other way–interested bidders who perhaps were not the first choice could decide they are no longer interested. It is important for the appraiser to consider the number and timing of serious offers (IOIs and LOIs) received up to the gift transfer date, as well as how spread out those IOIs and LOIs are.

Types of Bidders. More financially sophisticated bidders are probably more likely to close a deal, especially in later stages of the M&A process. A private equity firm or a public company with a dedicated M&A team is more likely to find issues and back out of bidding earlier in the process.

Economic Conditions. The more stable the current state of the economy, the more likely that deals will successfully close.

Political Environment. As with economic conditions, a more stable political environment means less uncertainty which makes deal closings more likely.

Regulatory Environment. Communication services sector deals were more likely to be canceled, per the McKinsey analysis. This was partly due to communications and media being a highly regulated sector raising the possibilities for antitrust challenges. Higher regulation leads to possible antitrust and other challenges which can hinder deal closings.

“Clean” Financials. Companies that have strong financial records likely have a higher probability of completing a deal as there is a lower chance of issues arising during due diligence. Similarly, companies that have no or minimal owner-discretionary or unusual items in recent financial results are more likely to successfully complete a deal.

Predictable Cash Flows. It is likely that companies with more stable and predictable cash flows are more likely to successfully complete an M&A process. More predictable cash flow leads to greater clarity about the future expected performance of the business and that is attractive to potential buyers.

Industry. As shown in the McKinsey analysis, deals in certain industries are more likely to be canceled. We note that the McKinsey analysis is from the period of 2013 through 2018, and the results for each industry can change over time. We also note that consideration of industry overlaps with many of the other factors to consider.

Economics of Deal Proceeds

The Levels of Value

We now need to take a step back to discuss why the appraised value of a business in a no-sale scenario is different than what the expected proceeds would be in a sale. We can do this with the help of what business appraisers call the “Levels of Value.”

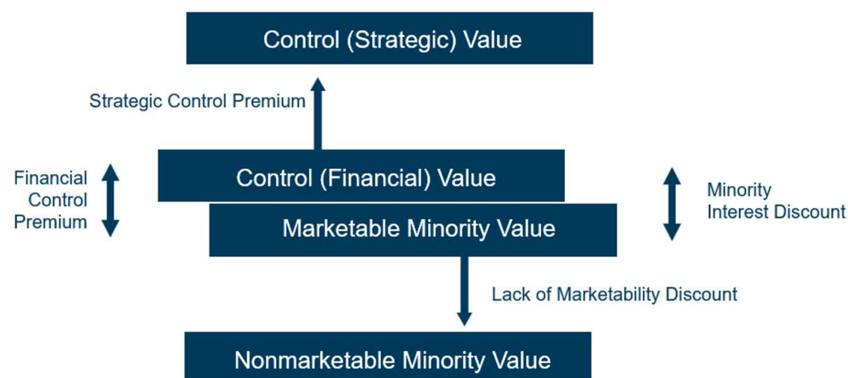
The Levels of Value Explained

Business owners and their professional advisors are occasionally perplexed by the fact that their shares can have more than one value. This multiplicity of values is not a conjuring trick on the part of business valuation experts, but simply reflects the economic fact that different markets, different investors, and different expectations necessarily lead to different values.

Business valuation experts use the term “level of value” to refer to these differing perspectives. As shown in Figure 4, there are three basic “levels” of value for a business.

Each of the basic levels of value corresponds to different perspectives on the value of the business.

Figure 4



Marketable Minority Level Value

The marketable minority value is a proxy for the value of a business if its shares were publicly traded. In other words, if the business had a stock ticker, at what price would the shares trade? To answer this question, we need to think about expectations for future cash flows and risk.

- **Expected cash flows.** Investors in public companies are focused on the future cash flows that companies will generate. In other words, investors are constantly assessing how developments in the broader economy, the industry, and the company itself will influence the company's ability to generate cash flow from its operations in the future.

- **Public company investors have a lot of investment choices.** There are thousands of different public companies, not to mention potential investments in bonds (government, municipal, or corporate), real estate, or other private investments. Public company investors are risk-averse, which just means that–when choosing between two investments having the same expected future cash flow–they will pay more today for the investment that is more certain. As a result, public company investors continuously evaluate the riskiness of a given public company against its peers and other alternative investments. When they perceive that the riskiness of an investment is increasing, the price will go down, and vice versa.

The marketable minority value is a proxy for the value of a business if its shares were publicly traded.

So, when a business appraiser estimates the value of a business at the marketable minority level of value, they are focused on expected future cash flows and risk. They estimate this value in two different ways.

1. Using an income approach, they create a forecast of future cash flows, and based on the perceived risk of the business, convert those cash flows to present value, or the value today of cash flows that will be received in the future.

2. Using a market approach, they identify other public companies that are similar in some way to your family business. By observing how investors are valuing those "comps," they estimate the value of the shares in the business.

While these are two distinct approaches, at the heart of each is an emphasis of the cash flow-generating ability and risk of the business.

We started with the marketable minority level of value because it is the traditional starting point for analyzing the other levels of value.

Control Level of Value

In contrast to public investors who buy small minority interests in companies, acquirers buy entire companies (or at least a large enough stake to exert control). Acquirers are often classified as either financial or strategic.

- Financially motivated acquirers often have cash flow expectations and risk assessments similar to those of public market investors. As a result, the control (financial) level of value is often not much different from the marketable minority level of value, as depicted in Figure 4.
- Strategic acquirers, on the other hand, have existing operations in the same, or an adjacent, industry. These acquirers typically plan to make operational changes to increase the expected cash flows of the business relative to stand-alone expectations (as if the company were publicly traded).

The ability to reap cost savings or achieve revenue synergies by combining a target acquisition with their existing operations means that strategic acquirers may be willing to pay a premium to the marketable minority value. Of course, selling the business to a strategic acquirer means that the business effectively ceases to exist. The name and branding may change, employees may be downsized, and production facilities may be closed.

Nonmarketable Minority Level of Value

While strategic acquirers may be willing to pay a premium, the buyer of a minority interest in a business that is not publicly traded will generally demand a discount to the marketable minority value. All else equal, investors prefer to have liquidity; when there is no ready market for an asset, the value is lower than it would be if an active market existed.

What factors are investors at the nonmarketable minority level of value most interested in? First, they care about the same factors as marketable minority investors–the cash-flow generating ability and risk profile of the business. But nonmarketable investors have an additional set of concerns that influence the size of the discount from the marketable minority value.

- **Expected holding period**. Once an investor buys a minority interest in a business, how long will they have to wait to sell the interest? The holding period for the investment will extend until (1) the shares are sold to another investor or (2) the shares are redeemed by the business, or (3) the business is sold. The longer an investor expects the holding period to be, the larger the discount to the marketable minority value.
- **Expected capital appreciation.** For most businesses, there is an expectation that the value of the business will grow over time. Capital appreciation is ultimately a function of the investments made by the business. Public company investors can generally assume that investments will be limited to projects that offer a sufficiently high risk-adjusted return. On the other hand, private company shareholders occasionally have to contend with management teams that hoard capital in low-yielding or non-operating assets, which reduces the expected capital appreciation for the shares. All else equal, the lower the expected capital appreciation, the larger the discount to the marketable minority value.

The buyer of a minority interest ... will generally demand a discount to the marketable minority value.

- **Interim distributions.** Does the business pay dividends? Interim distributions can be an important source of return during the expected holding period of uncertain duration. Interim distributions mitigate the marketability discount that would otherwise be applicable.

- **Holding period risk.** Beyond the risks of the business itself, investors in minority shares of public companies bear additional risks reflecting the uncertainty of the factors noted above. As a result, they demand a premium return relative to the marketable minority level. The greater the perceived risk, the larger the marketability discount.

The "levels of value" reflect the real-world concerns of different investors in different circumstances.

Using the Levels of Value to Explain the Gap Between Appraised Value and Expected Sales Proceeds

When gifting or transfers of interests in a business are done for estate planning purposes, it is typical that a non-controlling or minority interest is transferred. The value per share would therefore be at the nonmarketable minority level of value. For example, let us assume that a 35% total discount is appropriate. The marketable minority value (or value on the same level as a publicly traded stock) is $100 per share, so the nonmarketable minority level value is $65 per share.

An outright sale of 100% of the business would be based on a control level of value, either strategic or financial control, depending on the types of potential buyers. For example, a strategic buyer that considers synergies may place a 30% control premium on the business being sold. The proceeds, before taxes and transaction costs, would be $130 per share. As can be surmised from our hypothetical example, the proceeds per share from a transaction can potentially be significantly more than the fair market value at the nonmarketable minority level of value.

Understanding Deal Proceeds

Expected proceeds from a potential deal should be expressed net of corporate taxes on the transaction and other deal-related expenses. The proceeds may not be received in cash upon closing of the deal. Deal terms may consist of any variety of non-cash consideration which needs to be converted, risk-adjusted, and time value of money adjusted to cash equivalency at the date of closing.

For example, there may be a gap between what the seller thinks the company is worth and what the buyer is willing to pay. The buyer may be willing to pay more if the company hits certain performance expectations following closing of the deal. This is where an earn-out or other form of contingent payment may come into play. In order to get a deal done, the seller may agree to receive part of the consideration if certain performance benchmarks are achieved post-closing. The buyer is agreeing to additional consideration if the business achieves certain performance benchmarks post-closing. The present value of the expected proceeds as of closing is what should be considered as an indication of value in a "sale-scenario."

Figure 5

	Time Until Proceeds Are Received			
	Upon Closing	1 Year	2 Years	3 Years
Proceeds	$5,000,000	$1,000,000	$1,000,000	$1,000,000
Likelihood of Achieving Metrics	100%	80%	80%	80%
Probability-Weighted Proceeds	$5,000,000	$800,000	$800,000	$800,000
Discount Factor @ 10%	1.0000	0.9091	0.8264	0.7513
Present Value of Expected Proceeds	$5,000,000	$727,273	$661,157	$601,052
Present Value of All Expected Proceeds	$6,989,482			

Consider the scenario in Figure 5 where the buyer and seller agree that $5 million in cash will be delivered to the seller upon closing, with an additional $1 million to be received by the seller at the end of the next three years following closing if the business achieves a certain level of EBITDA.

In this example, we assume that the company's probability of hitting the EBITDA target in a given year is 80%. We also assume that, based on the lack of full liquidity and risks of the earn-out payments being made, the appropriate discount rate for the earn-out cash flows is 10%. As shown, we first probability weight the earn-out payments to derive expected proceeds of $800,000 in each of the three years. We then apply a discount rate to arrive at the present value of all expected proceeds of approximately $7 million. We note that in this simple example, we ignore taxes and deal costs. The present value of expected proceeds after taxes and deal costs is the appropriate "indicated value" to consider from a "sale-scenario."

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Evaluating Expected Proceeds: After-Tax Considerations and Earn-Out Impact

Let us now review examples of how a no-sale scenario and potential sale proceeds are weighted to arrive at a concluded fair market value in various stages of the M&A process. We note that this is entirely hypothetical and the weightings can vary significantly in each stage of the M&A process based on the particular facts and circumstances.

Figure 6

	No-Sale Scenario	Sale Proceeds	Value Conclusion
Pre-Transaction Process	100%	0%	$40,000
Marketing/CIM Distributed	↑	↓	↓
IOIs Received	↑	↓	↓
LOIs Received	↑	↓	↓
Deal Closed	0%	100%	$65,000

Continuing from the earn-out example above, we assume that after taxes and deal costs, the present value of the proceeds from the business being sold are $6.5 million. The business has 100 shares outstanding, so the proceeds per share are $65,000. If the business were not being sold, a typical appraisal process considering an income, market, and asset approach would have concluded a fair market value of $40,000 per share on a nonmarketable minority level of value.

Prior to any transaction process starting, and before any advisors are hired, all consideration would likely be given to the no-sale fair market value. If the company was considering selling in the near term it would have an impact on the discount for lack of marketability, even though a process had not been started. As shown in Figure 6, the fair market value per share used for any transfers would be $40,000.

Transfers of shares made between the beginning of the transaction process and prior to receiving any IOIs is where determining the appropriate weighting of a no-sale scenario and the expected sales proceeds is the most difficult. There is no useful data publicly available for likelihood of transaction completion this early in the marketing process. However, expected proceeds should be weighted in based on what the seller and their advisors think the most likely sale price will be. In this situation, the concluded weighting of the no-sale scenario and sale proceeds, and thus the concluded fair market value of the gift, depends on consideration of all factors surrounding the company, potential pool of buyers, and the transaction process, and may result in a concluded fair market value of anywhere between the indicated values from the no-sale scenario ($40,000) and the sale proceeds ($65,000).

In the scenarios in which transfers are made after the IOIs and LOIs are received, increasing weight would be assigned to the present value of expected sales proceeds. Unique factors impacting the due diligence process of a specific transaction could shift the applicable percentages for the no-sale and sale scenarios.

Once a deal has closed, all weight should be given to the present value of the expected sales proceeds. In this example, the reported fair market value of the transfer of one share would be $65,000. We note that there could be room for a discount for lack of marketability if there is material time between the transfer of the shares (valuation date) and the deal closing with proceeds received by the seller.

The later in the process that a transfer occurs, the higher the fair market value of that transfer for tax reporting purposes–all else equal. While this is not new, planning earlier is better even if a transaction process has already begun.

Conclusion

As with any valuation assignment, an appraiser tasked with valuing a business engaged in a sale process must draw on the principles of common sense, informed judgment, and reasonableness. The complexity of the task is much greater, however, when appraising a going concern that may soon sell.

The appraisal should consider IRS guidance on the matter, including CCA 202152018. In addition, the project might benefit from available market data regarding success rates of public M&A deals. The appraisal should be prepared in the knowledge and context of the ongoing transaction process. The details of the transaction process, including, but not limited to, the factors discussed in this whitepaper, should be considered.

Mercer Capital has the experience and expertise needed in these types of engagements. To discuss a valuation issue in confidence, please contact one of our professionals.

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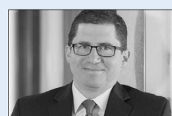
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