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Helping Families Preserve and Protect Assets and Values

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May 13, 2007

THOUGHT YOU'D LIKE TO SEE (OR SHARE) THIS

(Please feel free to share this with a friend or client who has a business.)

What is a Closely-Held Business? It is an entity in which or where:

- there are a limited number of owners (shareholders or partners),
- restrictions are imposed on an owner's ability to transfer his or her interest,
- there is no listing of the stock or interest on an exchange or regular quotation in "over the counter" markets,
- where the company has a no or an irregular, limited history of being sold or exchanged.

All or any one of these factors not only helps define a closely-held business, they significantly impact on its valuation. The mere fact that such a business has seldom, if ever, been traded and there is little, if any, market for it will be a major determinant of value.

Why Would An Owner Want to Value Their Closely-Held Business? There are many reasons why an owner might need or want to value his or her closely-held business. These include:

- planning for estate liquidity,
- making a gift to a family member, a friend or charity,
- assessing worth in a pre- or post-nuptial agreement or a marital dissolution,
- ascertaining worth for loan collateral purposes,
- performing a "fiscal checkup" to test the financial health of, or trends in, the business,
- estimating value should a buy-out be necessitated by death or disability, at retirement, or the sale of an interest in the business to a third party.

What's the Best Time to Set Price? *The proper time for setting the price where the triggering event occurs at an owner's death, disability or termination of employment is right now!* Almost all businesses with two or more owners should have what is called a "buy-sell" agreement, a document spelling out the terms and conditions of what is to happen and who must do what upon certain events.

The best time for setting the price or better yet the way in which the price will be determined is when the buy-sell agreement is drafted by your attorney. Otherwise, the buy-sell agreement guarantees only uncertainty and increases the likelihood of litigation with the other parties to the agreement, and probably with the IRS.

What Criteria Should The Price-Setting Formula Meet? Whatever price-setting mechanism owners agree upon (directly or by formula), it should meet five criteria. It should be (1) reasonable, (2) fair, (3) workable, (4) and understandable. While it is tempting to believe that a simple formula will produce an acceptable value there are many many situation where a formula will not come close to meeting the four criteria. An excellent book, though somewhat detailed, on buy-sell valuation issues that should be addressed is ***Buy-Sell Agreements*** *Ticking Time Bombs, or Reasonable Resolutions?* by Z. Christopher Mercier, ASA, CFA.

There is no "right" valuation formula or method; the method or combination of methods which should be used depends on the specific facts and circumstances of the case. The more thorough, objective, and rational the process, the more likely it will be respected by the IRS and the courts for both tax and other purposes. This is one of the principal reasons why an independent valuation specialist, someone who hold the ASA or CVA designation and is in the business of valuing business, should be retained.

Is it True That a Higher Value Isn't Always The Best Value? A high valuation means that a decedent owner's heirs receive more cash (assuming the agreement was properly and fully funded). It also means the buyers (surviving owners) must pay more for the interest. This seems to lead to higher federal estate taxes. But, keep in mind the impact of an unlimited federal estate tax marital deduction and the big increases in the applicable exclusion amount available under the current transfer tax system.

A lower valuation means less cash is received by the heirs of a deceased shareholder. The corresponding advantage is that the business entity or surviving owners need to make a smaller outlay to buy out the decedent owner's interest. A buy-sell agreement combined with a deferred compensation agreement may provide better result for the surviving owner than a high non-deductible purchase of the deceased shareholders interest.

Is There a Way to "Ball-Park" a Number? Here's a quick "reality check:" Let's assume you and your business associate(s) have knowledge of the relevant facts about the finances of the business. Put two slips of paper in front of each and ask each co-owner to answer two questions:

1. What is the most you would pay for the stock - if I owned it?
2. What is the least you would take for the stock - if I wanted to purchase it?
3. What would be the source of funds to pay the purchase price?

This "bid and asked" price technique will help establish an acceptable, if rough, ballpark price range, and help everyone to arrive at a realistic figure.

Of course, there's a lot more to the process of valuation—which is best accomplished by a your client's advisors (financial planner, CPA, attorney and valuation specialist) collaborating together!

AS ALWAYS, PLEASE FEEL FREE TO CALL TO DISCUSS THESE OR OTHER FINANCIAL ISSUES OF IMPORTANCE!

Sincerely,
Weatherby & Associates

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