

Estate Planning Valuation Insights

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DIFFERENCES IN THE ESTATE TAX VALUATION OF BIG BUSINESSES AND SMALL BUSINESSES

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For estate planning valuation purposes, many valuation analysts approach the small, family-owned business or professional practice exactly the same way that they approach the most substantial private corporation. Similarly, for estate tax valuation purposes, many Internal Revenue Service engineers and economists approach the small, closely held business exactly the same way that they approach the largest closely held corporation. In fact, there are more differences between small businesses and large businesses than the size of their financial statement accounts. This discussion summarizes many of the structural, operational, and strategic differences between small businesses and big businesses. And, this discussion explains the significance of these differences from the perspective of the estate planning/estate tax valuation.

INTRODUCTION

Many valuation analysts appraise small businesses and large businesses pretty much the same way for estate planning and estate tax purposes. This is true for analysts working for the estate and for analysts employed by the Internal Revenue Service (the Service).

The valuation of an equity ownership interest in a closely held business is an important consideration in many estate planning and estate tax engagements. And, the closely held business interest owned by the high net worth individual or decedent can range from a small, local operating business to a multi-billion-dollar corporation. Unfortunately, many valuation analysts apply the same set of approaches, methods, and procedures to the valuation of smaller businesses that they do to the valuation of billion-dollar corporations. They erroneously ignore many of the important operational and financial differences between big businesses and smaller businesses. This discussion describes many of these differences from an estate planning/estate tax valuation perspective.

DIFFERENCES BETWEEN BIG BUSINESSES AND SMALL BUSINESSES

There are numerous differences between the valuation of a big business and a small business—particularly with regard to closely held equity interest valuations performed for estate planning or estate tax purposes. Analysts who work for the estate or for the Service should carefully consider these differences (1) in their selection of valuation meth-

ods, (2) in their application of valuation procedures, (3) in their search for and analyses of transactional data, and (4) in their synthesis of value indications to reach the final value conclusion. In fact, the recognition of the appraisal subject either as a big business or as a small business is an important initial step in the estate planning/estate tax business valuation process.

There are three principal categories of differences between a big business and a small business that affect the closely held equity interest valuation analysis. These three categories are:

1. structural differences—including operational, financial, and legal differences;
2. transactional differences—meaning the way that such businesses are actually bought and sold; and
3. market differences—in data, methodology, and analytical factors that are directly involved in the valuation process.

It is important to note that there are no hard and fast valuation rules with regard to the differences between a large business and a small business. In fact, there are no hard and fast rules as to the definitions of—or the distinctions between—a large business and a small business. Indeed, in terms of the three categories of differences mentioned above, not all big businesses are the same. Likewise, not all small businesses are the same.

Experienced business valuation analysts do, in fact, consider these fundamental differences in their valuation

analyses. So, in one respect, this discussion is more directed to accountants, lawyers, and estate planners. However, this discussion may prove to be a good review (or provide a convenient checklist) for even the most experienced valuation practitioners—and for high net worth individuals (and their advisers) involved in the valuation of closely held business interests.

Definitions and Distinctions

There is no clear and succinct definition of what qualifies as a big business versus a small business. Likewise, there are no unambiguous and precise distinctions between big businesses and small businesses. The only fact that may be unambiguous when comparing big businesses and small businesses is that the distinctions are based on many more factors than size. Table 1 presents a list of several factors that distinguish big and small businesses, from a valuation perspective. This list is not intended to be comprehensive.

Structural Differences

The valuation analyst should consider the differences in the structure and operations of large businesses versus small businesses. Such differences do affect the availability of data for—and the analyses prepared during—the estate planning/estate tax valuation.

Table 2 presents a nonexhaustive list of illustrative differences in the operations of big businesses versus small businesses.

Consideration of these structural differences is important because, after all, the analyst needs to understand the workings (both financial and operational) of the valuation subject.

Transactional Differences

The valuation analyst should consider the differences in transactions involving a large business versus a small business. These transactional differences involve, simply, how the business would sell—if and when the business were put up for sale.

Table 3 presents a nonexhaustive list of illustrative differences in how a big business is sold versus how a small business is sold. Consideration of these transactional differences is important because the analyst is trying to model the actual market dynamics of willing buyers and willing sellers in the estate planning/estate tax valuation process.

Market Differences

The valuation analyst should consider the differences in actual valuation variables and data elements between a big business and a small business. Clearly, these factors will directly affect the valuation methods selected, procedures performed, analyses made, and conclusions reached.

Table 4 presents a nonexhaustive list of the market differences between a big business and a small business. Consideration of these factors is relevant since they may directly affect the data used and the judgments made in the business ownership interest valuation.

SUMMARY AND CONCLUSION

These differences between a big business and a small business may be second nature to experienced valuation analysts. However, they may not be intuitively obvious to less experienced valuation analysts or to high net worth individuals (and to their advisers).

Nonetheless, these differences deserve serious consideration in the valuation of a closely held business interest—particularly in the valuation of a closely held business interest for estate planning or estate tax purposes.

Clearly, these differences affect the availability of data, the applicability of valuation methods, the identification of valuation discounts and premiums, the quantification of capitalization rates and multiples, the consideration of transactional comparability, the analysis of a cash equivalency price, and—ultimately—the estimation of the fair market value of the subject closely held business.

For these reasons, the valuation of a small business is often more professionally challenging than the valuation of a big business. This may seem counterintuitive, because novice valuation analysts often start their professional careers assigned to the analysis of small businesses.

Nonetheless, as the factors outlined in this discussion should indicate, the estate planning/estate tax valuation of a small business often requires more experience and judgment than the estate planning/estate tax valuation of a big business.

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Table 1
Definitional Differences Between
Big Businesses and Small Businesses

| Item | Factor | Big Businesses | Small Businesses |
|-------------|--|--|--|
| 1 | Size in revenue | generally over \$50 million* | generally less than \$50 million* |
| 2 | Ownership | some outside (nonemployee or nonfamily) owners | all inside (employee or family) owners |
| 3 | Legal form | typically a corporation | may be partnership or corporation |
| 4 | Tax form | typically a C corporation | may be an S corporation or a partnership |
| 5 | Management | all professional managers (and few family member managers) | some family member/owner managers |
| 6 | Perceptions of business (separately consider perceptions of bankers, customers, suppliers, competitors, employees, and management) | company operates as a separate entity from its owners | company operations are inseparable from its owners |
| 7 | Ownership transition | company expected to easily survive a transaction from its current owners | company may not survive a transition from its current owners |
| 8 | Institutional attributes | company typically operates as an institution with numerous operating business entities (often with considerable diversification) | company typically operates as a single operating business unit (often with no diversification) |
| 9 | Locations | numerous locations that require separate decentralized management teams | may have one location (or a few locations) with one centralized management team |
| 10 | Management/organizational style | internal style/perception that "we are a part of a very large organization" | internal style/perception that "we are a closely held business" |

* These revenue thresholds are illustrative only for purposes of this discussion.

Table 2
Structural and Operational Differences Between
Big Businesses and Small Businesses

| Item | Factor | Big Businesses | Small Businesses |
|-------------|--------------------------------------|--|---|
| 1 | Debt financing availability | generally available—and independent of the credit-worthiness of the individual owners | generally less available—and not independent of the credit-worthiness of the individual owners |
| 2 | Debt financing guarantees | typically business owner's guarantees are not required | typically business owner's guarantees are required |
| 3 | Debt financing from owners | typically few loans from stockholders | often find loans from stockholders |
| 4 | Organization | owners are separate from management | owners are management |
| 5 | Compensation | employees paid wages for services; owners receive nonwage distributions; compensation for services and compensation for ownership are separate | employee/owners may be paid more or less than market wages; owners pay out all profits to themselves; compensation for services and return on ownership investment may be inseparable |
| 6 | Separate accounting | few transactions between the business and its owners | frequent transactions between the business and its owners (e.g. receivables, payables, personal expenses, extra bonuses) |
| 7 | Owners' personal expenses | not paid by the closely held business | often paid by the closely held business |
| 8 | Management | will have outside board members and outside senior management | all board members and all senior management are insiders |
| 9 | Separate transactions | company has separate transactions from its owners | company transactions are often not separable from its owners |
| 10 | Investment diversification | owners have other investments | all owners' wealth tied up in the business |
| 11 | Operational transactions with owners | generally few transactions with the owners | owners often own real estate and other assets— and lease these to the company |
| 12 | Capital type | equity from outside (nonemployee or nonfamily) owners; unsecured debt | equity from inside (employee or family) owners; secured debt |
| 13 | Capital mix | often more debt than equity | often more equity than debt |
| 14 | Capital cost | lower cost of debt lower cost of equity | higher cost of debt higher cost of equity |

Table 3
Transactional Differences Between
Big Businesses and Small Businesses

| Item | Factor | Big Businesses | Small Businesses |
|-------------|---------------------------------|--|---|
| 1 | Buyer motivations | based on objective analysis of return on investment and/or return on equity | buyer's motivations are often personal and subjective—owner's salary is sometimes considered part of the total return on investment |
| 2 | Type of broker | regional or national investment banker | business broker, industry specialized |
| 3 | Transaction cost | relatively lower—as a % of total business price | relatively higher—as a % of total business price |
| 4 | Transaction time | shorter time to close—compared to total price | longer time to close—compared to total price |
| 5 | Professional advisors | lawyers, accountants, investment/merchant bankers, financial advisers are all involved | fewer professional advisers are typically involved |
| 6 | Reasons to buy/sell | typically business-related | typically personal |
| 7 | Acquisition financing | from buyer and from unrelated financing sources | from seller and from company's traditional financing sources (e.g. commercial bank) |
| 8 | Stock versus asset sale | typically stock sale | sometimes asset sale |
| 9 | Properties included in sale | all business assets included in the company stock | personal assets (e.g. owner-owned real estate) must be sold separately |
| 10 | Consideration paid for | sale of stock only | sale of business and noncompete and transitional employment agreements |
| 11 | Earn-out provision | less common | more common |
| 12 | Types/number of possible buyers | numerous | few |
| 13 | Sale of business conducted | nationally | regionally |
| 14 | Type of buyer | often is a diversified passive/financial investor | often will be active owner/manager (may be a current competitor or employee) |

Table 4
Market Differences Between
Big Businesses and Small Businesses

| Item | Factor | Big Businesses | Small Businesses |
|-------------|---|--|---|
| 1 | Guideline public company data | guideline companies available | often guideline companies not available |
| 2 | Guideline merged and acquired company data | guideline companies available | often guideline companies not available |
| 3 | Subject prospective financial information (e.g. budgets, projections, plans) | generally available | often not available |
| 4 | Subject prospective operational information (e.g. budgets, forecasts, plans) | generally available | often not available |
| 5 | Detailed listing of assets (tangible and intangible) | generally available | often not available |
| 6 | Estimates of individual asset values (e.g. through management experts, property tax renditions, prior asset appraisals) | generally available | often not available |
| 7 | Applicability of valuation discounts: key person, key customer, key supplier, lack of diversification-product, lack of diversification-location, obsolescence-plant, obsolescence-technology, obsolescence-products | generally less applicable | generally more applicable |
| 8 | Owner exit plan | will likely be in place; at least exit is possible (e.g. an IPO) | will likely not be in place; exit may not be possible |
| 9 | Historical financial data quality | typically audited, comply with GAAP | often not audited, may not comply with GAAP |
| 10 | Historical financial data quantity | generally adequate | often may not be adequate |
| 11 | Historical operational data | generally adequate | often may not be adequate |
| 12 | Confer with outside company advisers (e.g. accountants, lawyers) | generally available | often not available |
| 13 | Availability of industry data | typically subject is a member of industry trade association | subject may not be a member of industry trade association |
| 14 | Availability of competitive position | typically management has accurate data on competitive position | management may not have accurate data on competitive position |
| 15 | Availability of competitive data | data available on public competitors | data may not be available on small, closely held competitors |
| 16 | Availability of economic data | national/regional economic data apply—and are readily available | local economic data apply—and may not be readily available |