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Valuing a Closely Held Business

For many small business owners, valuing a **closely held business** is an important part of estate and financial planning. Because valuation is a multi-faceted endeavor, a comprehensive approach is needed. Equity interests in a closely held business are not frequently sold or otherwise transferred, which can make it difficult to ascertain a valuation. Therefore, valuing a business (a **sole proprietorship**, a **partnership**, or a **corporation**), involves an analysis of specific conditions that can affect closely held businesses.

Getting Down to Business

Whenever there is a need to perform a business valuation for estate purposes, there are potentially seven areas that must be researched in order to arrive at a fair value for the total business. Each area may address issues that are somewhat abstract and/or difficult to quantify. Here is a general overview:

1) The nature, scope, and history of the business operation must be reviewed. The product or service rendered must be evaluated by past performance, as well as the risks inherent in all phases of operations. While disregarding past events that are unlikely to recur, capital structure, sales records, growth, and diversity of operations can speak volumes about the past and even future performance of the business.

2) By analyzing both related business sectors and current economic conditions, an appraisal can be made regarding the future potential for business profits. Generally, the greater the expectation of profits, the greater the value of the business. The appraiser should evaluate the industry, as well as the position of the particular business within the industry. The economic climate may impact the ability of all businesses to generate profits. Often, insight can be gained from looking at several competitors' past performance and future growth potential.

3) Book value, defined as assets minus liabilities, is readily obtained from the balance sheet. However, in most cases, balance sheet adjustments according to book value will need to be made for an accurate reflection of economic versus tax depreciation.

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A Vacation Home: The Ultimate Hideaway

Are you dreaming of a mountain cabin or an oceanfront bungalow hideaway? Then you may want to consider that a vacation home can offer some tax savings. Whether you choose to use the home solely for enjoyment or combine business and pleasure by renting the property part-time, it is important to understand the tax laws for a second home.

If you use the place as a second home—rather than renting it out—interest on the mortgage is deductible within the same limits as the interest on the mortgage on your first home.

For tax years prior to 2018, you can write off 100 percent of the interest you pay on up to $1.1 million of debt secured by your first and second homes and used to acquire or improve the properties. For tax years after 2017, the limit is reduced to $750,000 of debt secured by your first and second home for binding contracts or loans originated after December 16, 2017. For loans prior to this date, the limit is $1 million ($1.1 million without the $100,000 home equity portion).

This advantage is restricted to two homes. Should you purchase a third home, interest on that mortgage is not deductible. However, regardless of how many homes you have, you may be able to deduct the property tax paid. Property taxes are still deductible in 2018 and beyond. However, the Tax Cuts and Jobs Act has limited the deduction to a $10,000 annual cap. When you consider this fact, combined with the higher standard deduction ($24,400 in 2019) that will make itemizing not worthwhile for most people.

One break enjoyed by homeowners—the right to immediately deduct points paid on a mortgage—applies only to a principal residence. Points paid on a loan for a second home must be deducted gradually, as the mortgage is paid off.

Personal Residence

Your vacation home is considered a personal residence if you rent it for no more than 14 days a year. In such a situation, you may retain the rent tax free without jeopardizing your mortgage interest and tax deductions. However, you may not deduct any rental-related expenses. If you rent out the house on a continual basis, things may become more complicated. Depending on the breakdown between personal and rental use, different rules may apply.

If you buy primarily for pleasure but rent for 15 days or more, the rent you receive is taxable. Because the house is still considered a personal residence, you may deduct all of the interest and property tax (The allocation of property tax between personal use and rental use may help with managing the $10,000 cap on personal state and local taxes.). You may also be able to deduct other rental-related expenses, including the cost of utilities, repairs, and insurance attributable to the time the house is rented. In some cases, you may be able to deduct depreciation. When the house is considered a personal residence, rental deductions cannot exceed the amount of rental income you report. In other words, your second home cannot produce a tax loss to shelter other income. In most cases, the interest and taxes assigned to the rental use of the house combined with the operating expenses more than offset rental income, thus limiting your ability to write off depreciation.

Rental Property

Now consider your tax situation if you buy a property primarily as an investment and limit your personal use of the property to 14 days a year (or 10% of the number of rental days, whichever is greater). Because the house is a rental property according to the Internal Revenue Service (IRS), your deductions can exceed the amount you receive in rental income.

If your rental income does not cover the cost of renting the house, you may be able to claim a taxable loss. Rental losses are classified as passive and can be deducted only against passive income, such as that from another rental property that

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4) Profit and loss statements must be scrutinized to determine the company's earnings history. While the Internal Revenue Service (IRS) may require the past five years of profit and loss statements, for example, the agency generally will not respect five-year earnings averages, due to the belief that averages do not indicate realistic valuations. It is common for appraisers to "capitalize" earnings as a means of reducing future income to a single number, otherwise referred to as present value. Capitalizing earnings is a method used to determine how much an individual will pay for a business given the level of risk involved. Typically, the greater the risk, the less the buyer will pay, and vice versa.

5) Where appropriate, the dividend-paying capacity of the company will be determined from financial statements. However, dividends may not be a reliable criterion of market value for a closely held company since the controlling stockholders may have used discretion in opting to pay deductible salaries and bonuses, rather than nondeductible dividends.

6) The most difficult area for valuation purposes is goodwill, or the ability of a business to earn a return over and above what it could on its fixed assets alone. Consumer satisfaction, trust, and trademarks may be important factors in gross revenues. In addition, intangible goodwill value can be based upon location, reputation, or clientele. While it may be difficult to determine a precise valuation, an independent appraiser may be able to discern the overall significance of the company's goodwill.

7) If shares were purchased in the last three years, for example, the price paid for an interest in the business may be a significant factor in valuation for a closely held business. In this case, the IRS may scrutinize when the sale was made, whether the interest sold was controlling or a minority block, and whether or not the sale was forced by other conditions in the business or circumstances associated with the buyer or seller.

Wherever possible, each area must be reduced to specific numerical values. The IRS cautions against averages to prevent the appraiser from simply averaging factors, such as book value, goodwill, and capitalized earnings, and then coming up with a figure. Courts generally agree with the IRS in not giving credence to averages and formulas. As a result, valuation has become more complicated.

While determining the valuation of a closely held business may seem overwhelming at first, it may prove useful in estate and financial planning, as well as **business succession planning.** Because the valuation process is intricate and involves many variables, be sure to consult with qualified professionals. ■

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realizes a gain. If you do not have passive income to shelter, the losses have no immediate value; however, unused losses can be used in the future when you have passive income.

There's an exception to this rule, however, that permits taxpayers with adjusted gross income (AGI) under $100,000 ($50,000 if married filing separately) to deduct up to $25,000 ($12,500 if married filing separately) of passive losses against other kinds of income, including salaries. To qualify, you must actively manage the property. The $25,000 allowance is gradually phased out for taxpayers whose AGI is between $100,000 and $150,000.

If your vacation home is considered a rental property, the mortgage interest attributable to the time the premises are rented is a business deduction. The remainder cannot be deducted as home mortgage interest since the house doesn't qualify as a personal residence.

These tax laws also apply to apartments, condominiums, mobile homes, or boats with basic living accommodations. Generally, these are considered rental properties if they include a sleeping space, bathroom, and cooking facilities. If you are considering the purchase of a vacation home, keep in mind that, from a tax perspective, that mountain cabin or oceanfront bungalow may be the ultimate dream home. ■

Some Things to Consider When Making Regular Charitable Gifts

Sometimes, our desire to give can lead us into making commitments that are difficult to fulfill. Any endeavor worth undertaking, especially one that can benefit others, deserves our careful consideration *before* we take action. Therefore, when contemplating charitable giving, you may want to consider the following points:

- **Choose your causes.** Worthy causes abound and often demand our immediate attention. Choose a limited number of organizations that concentrate on areas that are important to *you*, and then research what kind of help is needed.
- **Budget your gifts.** Include charitable gifts when planning your annual budget. Distributing your donations throughout the year may lessen the impact on your finances and increase the total you may be able to give.
- **Plan your volunteer activities.** Volunteering can be a rewarding experience, especially when you're able to see the fruits of your labor. Carefully determine the time you have available to ensure your best efforts for the cause, and avoid taking on too much.
- **Review your plans.** Just as you review your annual financial budget, look at your annual time/value budget. Revise your volunteer commitments to include those where the rewards have been the greatest for both you and your cause.
- **Consider a testamentary gift.** If you are fortunate enough to be in a position to increase the amount you donate, or if you are concerned about the future of the organizations you support, consider making a testamentary gift.

Testamentary Gifts

Generally, a testamentary gift is a promise of funds to be given from your estate upon your death. However, using your estate in this way may cause complications. Your intended gift could be reduced if any of the following apply:

- The fair-market value of your assets decreases before your death.
- Unforeseen estate expenses must be met from your assets.
- Your will is contested.

You may be able to protect your gift from estate problems through the establishment of a **trust**. However, the associated legal and administrative costs may have an adverse impact on your gift.

Protection for Your Charitable Gift

Your intentions—and your gift—can be protected from the complications above through the use of **life insurance**. The potential of life insurance may even result in a larger gift than you had originally intended.

The policy can be owned by the charity and removed from your estate, generally protecting your gift from taxation, creditors, and legal contest. It can be purchased and maintained with funds that you contribute to the charity, and as such, your contributions are tax deductible as a charitable gift. As owner of the policy, the charity can decide whether to use your gift to pay the premiums or let the policy lapse. As **beneficiary**, the charity will receive the proceeds of the policy at your death. Depending on the type of policy purchased and the charity's willingness to use your contributions to maintain the policy, these proceeds may be guaranteed and may increase over time. In addition, the proceeds may exceed the amount you would have otherwise given outright during your lifetime or upon your death, depending on the policy type and other factors.

The satisfaction that can come from preparing your charitable gifts ahead of time can be extremely rewarding. When protected with life insurance, your gift could result in the ability to yield more than you ever imagined possible. It may help provide essential funding for your chosen organization, enabling the continuation of its good work.

Be sure to consult a qualified insurance professional to determine the appropriate strategy for your unique circumstances. ■

All insurance guarantees are based on the financial strength and claims paying ability of the issuing insurance company.