Thought Leadership Discussion

Valuation Considerations for Gift and Estate Tax Planning and Compliance Purposes during Economic Uncertainty

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The valuation of a privately held business or business ownership interest becomes more complex during periods of economic uncertainty. This discussion summarizes observations from recent events affecting global economies, and it focuses on the implications for gift and estate tax valuations. Understanding the economic outlook at the specific valuation date establishes the context for valuation analysts and regulatory agencies to assess expectations regarding future performance of a privately held business or business interest. This discussion presents several factors that analysts may consider when estimating fair market value for gift and estate tax purposes during economic uncertainty. The current environment may provide an opportunity for the owners of private businesses and business interests to evaluate their wealth planning goals, strategies, and objectives in order to maximize future benefits.

Introduction

Uncertainty is generally thought of as a state of doubt. It applies to predictions of future events, to physical measurements that are already made, or to the unknown.[1]

In today's economic environment, businesses—particularly private businesses—are faced with multiple challenges. These challenges fill the business landscape with risk and uncertainty and are driven by:

1. the public health crisis and
2. the ensuing economic fallout.

Global Pandemic

Since the beginning of March 2020, the impact of the global pandemic has been felt across the world. According to the Center for Systems Science and Engineering at Johns Hopkins University, as of September 23, 2020, there were more than 31.7 million coronavirus cases reported with 972,000 deaths across the globe.

In the United States, the number of cases now exceeds 7 million with over 210,000 deaths. While these statistics are grim, the impact to U.S. businesses has also become alarming. An estimated 80,000 small businesses were permanently closed between March 1, 2020, and July 25, 2020.[2]

As the virus spread, many businesses considered nonessential were forced to temporarily close, resulting in a spike to the U.S. unemployment rate. Travel restrictions and social distancing protocols further compounded the contraction in economic activity throughout the United States.

While the full economic and social impact of the global pandemic may not be known for years, the implications from the temporary lack of activity are far reaching. The uncertainty of the outcome from the pandemic may have rippling effects as individuals and businesses may find it difficult to borrow funds from traditional sources as credit tightens. Households may postpone major purchases and businesses may delay investment decisions creating additional economic uncertainty.

While the vast majority of Americans hope the economy will quickly rebound and return to growth, there is no guarantee. As the time line for an effective vaccine and further economic stimulus remain in question, businesses will likely:

1. endure longer periods of uncertainty and
2. face increased exposure to risk.

Many businesses in fragile industries may not survive or ever return; others may find ways to adapt and prosper. In the near term, as existing restrictions are eased and activity levels increase, the threat of possible resurgence of the virus could jeopardize economic recovery or even push the U.S. economy into a double-dip recession.

Impact on U.S. Markets

To understand the impact of the pandemic on U.S. markets, Exhibit 1 presents selected capital market data before and after the onset of COVID-19. Trailing 2019 statistics reflect solid economic growth and strength with market indices approaching record levels before peaking in February.

The data illustrate significant volatility from the market peak (February 19, 2020) to the declaration of public health emergencies throughout the United States. Investor reaction was swift as the S&P 500 decreased 34 percent to its low on March 23, 2020.

The average implied S&P price to earnings ("P/E") multiples decreased as much as 25 percent and the yield on U.S. 20-year Treasury securities, a proxy for the risk-free rate, declined 41 percent. After initial declines, markets and P/E multiples rebounded but remain volatile.

According to the U.S. Bureau of Economic Analysis, real gross domestic product ("GDP"), decreased at an annual rate of 4.8 percent during the first quarter of 2020 and was attributed to the effects of the partial economic shut-down from the pandemic, marking the largest decrease since the last recession and the first decrease since 2014.

This decline reflected negative contributions from personal consumption expenditures, nonresidential fixed investment, exports, and private inventory investment, and were partly offset by positive contributions from residential fixed investment and government spending.[3]

Exhibit 1
Selected Capital Market Data before and after the Outbreak of COVID-19

	2019		2020		
Index	March 29	June 28	DJIA Peak	March 27	June 29
Dow Jones Industrial Average	25,928.68	26,599.96	29,551.42	21,636.78	25,015.55
U.S. 20 Year Treasury Securities	2.63	2.31	1.86	1.09	1.16
S&P Industrials	3,843.88	3,975.71	4,595.26	3,500.45	4,246.85
P/E Multiple	24.5	23.9	28.5	21.8	26.7
Dividend Yield	1.85	1.83	1.67	2.15	1.92
S&P 500 Composite	2,834.40	2,941.76	3,380.16	2,541.47	3,009.05
P/E Multiple	21.7	22.2	25.4	19.1	21.6
Dividend Yield	2.00	1.97	1.81	2.38	1.69
Nasdaq Composite	7,729.32	8,006.24	9,731.18	7,502.38	9,757.22

Sources: *Barron's (* 4-1-19, 7-1-19, 2-17-20, 3-30-20, and 6-29-20) and U.S. Department of Treasury (4-1-19, 7-1-19, 2-17-20, 3-30-20, and 6-29-20).

Valuation Considerations for Gift and Estate Tax Planning and Compliance

The following discussion presents considerations related to the valuation of a privately held business or business interest during periods of economic uncertainty. This discussion highlights definitions and guidance that are often referenced by valuation analysts.

This discussion also includes a summary of generally accepted valuation approaches and discount rates A detailed discussion of all business valuation approaches and methods, discount rates and capitalization rates, and market pricing multiples is beyond the scope of this discussion.

Business valuations used for gift and estate tax purposes should adhere to the applicable provisions of the Internal Revenue Code ("Code") and the Treasury regulations.

Regulation 20.231-2 states "in valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods and factors which must be considered in valuing such securities are outlined."

Business valuations performed for federal gift and estate tax purposes typically follow the factors listed in Internal Revenue Service Revenue Ruling 59-60. This revenue ruling states that the following factors are fundamental and should be considered in each case:

1. The nature of the business and the history of the enterprise from its inception
2. The economic outlook in general and the condition and outlook of the specific industry in particular
3. The book value of the stock and the financial condition of the business
4. The earning capacity of the company
5. The dividend-paying capacity
6. Whether or not the enterprise has goodwill or other intangible value
7. Sales of the stock and the size of the block of stock to be valued
8. Having their stocks actively traded in a free and open market, either on exchange or over the counter

As specified in Revenue Ruling 59-60, the fundamental factors considered in the gift-or-estate-tax-related valuation of a privately held business or business interest include consideration of the following factors as of the relevant valuation date:

1. The economic outlook
2. The condition and outlook for the specific industry

For gift tax purposes, the valuation date is the date of the taxable transfer. And, for estate tax purposes, the valuation date is the date of death or the alternative valuation date, six months following the date of death.

The valuation date defines the "overarching context in which the subject interest of the valuation is interacting with and affected by the internal and external environments to which the subject interest is exposed. There is significant consensus in the valuation profession that the as-of date defines the boundary between observable, measurable history and hypothetical expectations of the future."[4]

When conducting business valuation assignments, analysts gather, review, analyze, and compare large amounts of data within the context of the valuation date. Part of this diligence process may involve management interviews to gather facts about operations, competitive position, financial performance, and business plans. These interviews are generally conducted within the context of the valuation date to confirm what was known or knowable as of the valuation date.

To the extent management-prepared financial projections are provided by the private company, analysts should validate the process used to develop the projections—including the date the financial projections were prepared.

Valuations used for gift and estate tax planning and compliance purposes generally do not consider events and data[5] past the valuation date unless these events and data were known or knowable.

Because some businesses periodically update projections as part of the financial reporting process or as required by lenders or outside investors, analysts should understand and confirm the date the projections were prepared and confirm what was known or knowable as of the valuation date. In the current economic environment, analysts will need to understand what information about COVID-19 was known or knowable as of the valuation date.

The American Institute of Certified Public Accountants ("AICPA") Coronavirus (COVID-19) Resource Center suggests that information known about the coronavirus as of a specific date will likely be the subject of debate, and that information about the virus can be viewed at the date the virus was known to exist and the date when the virus affected the U.S. economy.

The AICPA further suggests these dates represent at least two different dates that the analyst will need to consider in developing and justifying assumptions used and considered in the valuation report.

However, if the valuation date is prior to the onset of the pandemic and if the intended user of the valuation considers information or events after the valuation date to be important and meaningful, then the valuation analyst may consider disclosing that information or events.

In developing fair market value estimates for privately held businesses or business interests, analysts consider the three generally accepted business valuation approaches: the income approach, the market approach, and the asset-based approach. Within each approach there are accepted methods, practices, and procedures for the application of each approach.

Valuations of privately held businesses or business interests prepared for gift and estate tax planning and compliance purposes can involve operating entities or holding companies. The fair market value of operating entities are often estimated by applying the market approach and the income approach, while the fair market value of asset holding companies is often estimated by applying the asset-based approach.

In the case of an operating company, the market approach considers the application of market multiples derived from guideline publicly traded companies and/or guideline company transactions operating the same or similar industry with similar characteristics. The income approach generally includes the application of a present value discount rate or a direct income capitalization rate.

When applying the income approach, the analyst may apply a present value discount rate or a direct capitalization rate depending on the income, earnings, or cash flow and selected method used in the valuation. A discount rate is defined as a rate of return used to convert a monetary sum, payable or receivable in the future into present value.[6]

A discount rate is also defined as the rate used to calculate the present value of earnings or cash flow at a specific point in time. In developing discount rates, certain components are developed from the analysis of market-derived data (e.g., risk-free rate, equity risk premium, size premium) as of the valuation date while other factors, specifically the unsystematic risk premium or company-specific risk premium, require professional judgment.

Discount rates may be applied to different measures of income including equity-related cash flow or invested-capital-related cash flow. Analysts typically match the appropriate discount rate with the selected income or cash flow metric. For example, in the case of invested capital cash flow, analysts typically use a weighted average cost of capital, and in the case of equity cash flow, analysts estimate an equity discount rate.

Mathematically, the cost of equity capital, or an equity discount rate, is calculated as follows:

$$K_e = RF + (R_n - RF) + SARP + IARP + URP$$

where:

K_e	=	Cost of equity-equivalent capital
RF	=	A measure of the risk-free rate of return
R_n - RF	=	The long-term equity risk premium
SARP	=	The size adjustment risk premium
IARP	=	The industry adjustment risk premium
URP	=	The unsystematic or company-specific risk premium

Included as a component of the cost of equity capital is the unsystematic risk or company-specific risk premium ("CSRP"). This component is intended to capture company-specific risk factors not accounted for in the size adjustment premium or industry adjustment risk premium. Analysts sometimes refer to this component as alpha, or simply as the CSRP.

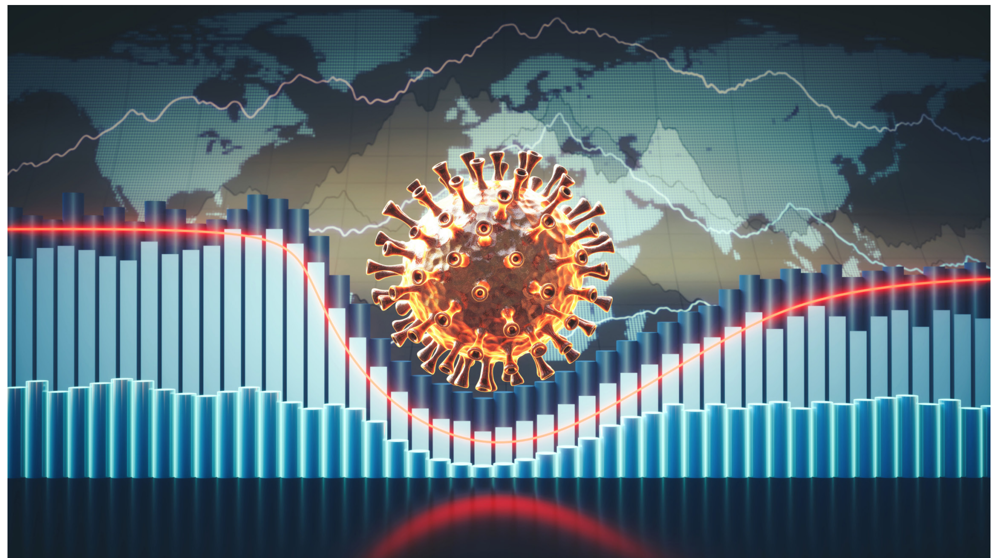
The mathematical equation for the cost of equity can also be thought of in the context of risk. That is, the cost of capital for any given investment is a combination of two basic factors:[7]

1. A risk-free rate, which is a rate of return that is available in the market on an investment that is free of default risk, usually the yield to maturity on a U.S. government security
2. A premium for risk, which is an expected amount of return over and above the risk-free rate to compensate the investor for accepting risk

A generally accepted definition of risk in the context of business valuation is the degree of

certainty or uncertainty as to the realization of expected returns.[8]

As the market's perception of the degree of risk of an investment goes up, the rate of return the market requires (the discount rate) goes up. The higher the market's required rate of return, the lower the present value of the investment.[9]



Valuation Considerations during Economic Uncertainty

During periods of economic uncertainty, the valuation of a privately held business or business interest may require additional diligence when estimating applicable discount rates and market-derived pricing multiples. In the current environment, the U.S. business cycle reached an inflection point and shifted from an expansion cycle to a recession cycle.

Given the significance of this economic shift, analysts may elect to consider alternative scenario analyses to ensure applicable market multiples and discount rates reflect economic uncertainty and incremental risk.

Capital market theory divides risk into two components: (1) systematic risk and (2) unsystematic risk.

Systematic risk is defined in the textbook *Valuing a Business: the Analysis and Appraisal of Closely Held Companies*,[10] as the uncertainty of future returns due to the sensitivity of the return on the subject investment to movements in the return for the investment market as a whole. Unsystematic risk is a function of characteristics of the industry, the individual company, and the type of investment interest.[11]

Systematic risk is generally considered through beta, which is measured by comparing the excess return on an individual security relative to the excess return on the market index.

Unsystematic risk is not directly observable and requires an analysis of risk factors specific to the subject business and the application of professional judgment.

Company-Specific Risk Premium

The CSRP is the risk premium associated with the level of unsystematic risk inherent in a particular business or business ownership interest. The CSRP can be positive or negative depending on the specific facts and circumstances associated with a privately held business or business interest.

The CSRP can be considered as the incremental risk premium needed to compensate an equity investor for the uncertainty of investing in a particular privately held business, business ownership interest, or intangible asset.[12]

The CSRP component of the discount rate should also be appropriately calibrated with the financial projections to avoid double-counting risk adjustments which may have already been incorporated into the projections. Analysts may also expect added scrutiny regarding CSRP given the professional judgment required and the fact that this premium has received more attention due to the economic fallout from the global pandemic.

Similarly, the selection of appropriate market multiples to reflect incremental risk may also be warranted. Analysts should also review historical financial data and consider the need for normalizing adjustments for nonrecurring items and specific adjustments to normalize the financial metrics of businesses affected by programs under the Comprehensive Aid, Relief and Economic Security ("CARES") Act. The AICPA provides further guidance for analysts when considering the impact of the CARES Act and any additional economic support programs as part of a valuation.

Analysts may consider adjustments to the CSRP based on competitive, financial, management, economic, and operational risk factors. Within these

risk factors, more detailed assessments may also be considered including the following:

Competition:

- Comparative assessment of projected revenue growth, margins, earnings/cash flow relative to industry peers
- Capital structure analysis/comparison relative to competitors
- Operating leverage peer comparison
- Business and product/services life cycle analysis
- Assess competitive position with the industry (leader, follower, positive, neutral, negative)
- Consider product/service differentiation factors and assess product/service life cycle
- Industry consolidation risk
- Product line concentration/diversification risk vs. competitors
- Supply and distribution chain constraints

Financial Strength:

- Historical and current volatility in revenue, margins, earnings, and cash flow
- Impact on revenue, margins, earnings, and cash flow due to changes in the economy and industry
- Cash conversion cycle, working capital requirements
- Changes in recurring/nonrecurring revenue and earnings (historical and projected)
- Customer turnover/attrition patterns and trends
- Changes in liquidity, debt levels, and reinvestment requirements
- Operating cash requirements and use of excess cash resources
- Access to debt and equity capital resources
- Insolvency risk
- Contingent liability risk
- Business life cycle stage

Management Strength/Depth and Workforce:

- Management turnover or loss of key employee/talent
- Key person consideration
- Management business and industry experience
- Management departures and subsequent competition
- Workforce skill level requirements
- Organized labor risk factors including strikes and management lockouts

National, Regional, and Local Economic Factors:

- Macroeconomics analysis, leading economic indicators for (e.g., GDP, unemployment, interest rates, market volatility, business failure rates, etc.)
- Business cycle, expansion/recession

Operational Factors:

- Facility limitations, excess or insufficient operating capacity
- Equipment failure and backup risk
- Geographical operating limitations
- Location advantages/disadvantages

There are a multitude of company-specific risk factors analysts may consider, and the factors presented above are not intended to represent a comprehensive list of all CSRP factors. However, the appropriate identification, consideration, and weighting of company-specific risk factors should result in a premium that appropriately reflects the incremental risk related to the specific business or business ownership interest.

Quantifying the CSRP may take different forms. Some analysts rely on qualitative assessment, others may apply numerical weighting to factors considered, but CSRP quantification is also a function of professional judgement.

The National Association of Certified Valuators and Analysts ("NACVA") provides guidance with respect to company-specific risk premiums. And, NACVA recommends consideration of the similar factors presented above when estimating CSRP.

In the current economic environment, many businesses have been reassessing financial projections, analysts should closely examine these projections and may need to consider alternative scenario analyses to reflect industry supply/demand imbalance or increased volatility in revenue, profit margins, and cash flow. The results from alternative scenarios may provide additional insight and support for an appropriate range of possible conclusions.

Analysts may also investigate where a business falls in the continuum of its life cycle (e.g., new,

growth, mature, decline) and further investigate the business life cycle within the context of the economic outlook and cyclical industry implications. These considerations may also influence the selection of an appropriate long-term (or terminal period) growth rate assumption.

The company-specific risk premium is considered directly in the application of the income approach when the analyst selects a discount rate or a capitalization rate for the valuation of a business ownership interest.[13]

The CSRP is also considered indirectly in the application of the market approach and the asset-based approach in the valuation of a business or business interest. To a certain extent, the magnitude of the selected CSRP may be influenced by the purpose of the business valuation.[14]

For example, the selection of the CSRP to be considered in the valuation of an equity interest for gift and estate tax transfer purposes may be influenced by the following considerations:

- The statutory, regulatory, judicial, or other standard of value selected or required for the valuation assignment (e.g., fair market value, fair value, investment value)
- The statutory, regulatory, judicial, or other level of value selected or required for the valuation assignment (e.g., controlling, marketable; noncontrolling, marketable; controlling nonmarketable; noncontrolling, nonmarketable)
- The statutory, regulatory, judicial, or other premise of value selected or required for the valuation assignment (e.g., value in continued use as a going concern, value in exchange as part of a disposition of asset)

Furthermore, in the consideration of the CSRP with regard to a specific privately held business, business ownership interest, or intangible asset as part of estate or trust, the analyst may be instructed by legal counsel regarding the relevant statutory authority, judicial precedent, or administration rulings with respect to the application of the CSRP.

The Delaware Court of Chancery (the "Chancery Court") has opined on the inclusion of the CSRP in numerous fair-value-related shareholder appraisal rights and shareholder oppression matters. In these judicial decisions, the Chancery Court has generally disallowed the inclusion of a CSRP in the cost of equity measurement for dissenting shareholder rights fair value valuations.

Noncontrolling Interest Considerations

For the privately held noncontrolling business interest, consideration of the current economic environment may affect applicable discounts for lack of control and lack of marketability based on liquidity concerns and limitations in the market. Further, as economic conditions fluctuate, the pace of merger and acquisition transaction activity may change, and control premiums could trend lower as market participants become more risk-averse to any slowdown in economic recovery or lower growth expectations in GDP.

Additional guidance from the AICPA specific to the development of a discount for lack of marketability suggests that analysts review holding periods from the perspective of a hypothetical willing buyer from the onset of the pandemic. This may affect the timing of a sale of a business or business interest which in turn may have an impact on the appropriate discount for lack of marketability.[15]

Analysis of expected growth in value over the anticipated holding period may force the elimination of dividends to bolster business liquidity and lower potential demand from noncontrolling interest investors.

Another factor to consider is how the impact from the pandemic affects the return premium

investors require for enduring illiquidity. Relative to returns on publicly traded shares, an increasing premium for illiquidity would contribute to a higher discount for lack of marketability while a lower illiquidity return premium may suggest a lower discount for lack of marketability.

As is the case for all valuations, well-documented work papers and valuation reports are needed to meet the reporting requirements for the valuation of a privately held business, or business interest for gift and estate tax planning and compliance purposes.

Planning Opportunities

Wealth planning opportunities should be considered and evaluated during times of economic uncertainty. This is because valuations for private businesses or business interests may be adversely affected by the shift in the business cycle or changes in supply and demand patterns, industry trends and cycles, and the multitude of company-specific factors which may collectively increase the risk profile of a specific business.

On the cusp of the presidential election, the risk of changes to current tax provisions, including significant reduction to existing exclusion limitations or the implementation of gift and estate tax proposals by Congress, could be accelerated or materially modified by a new political regime.

Summary and Conclusion

This discussion presented observations regarding the economic fallout from the recent global pandemic. And, this discussion summarized several analyst considerations when estimating the fair market value of a privately held business or business interest for gift and estate tax planning and compliance purposes during periods of economic uncertainty.

The current economic environment has created an opportunity for individuals and families to evaluate their estate plans and consider additional wealth planning strategies.

For individuals and families seeking to maximize the benefits of the current exemption limitations for gift and estate and generation-skipping transfers of $11.58 million per individual or $23.16 million per couple, the window may be closing quickly as the November election season and the risk of potential tax law changes draws near.

Notes:

1. Peter Norvig and Sebastian Thrun, "Introduction to Artificial Intelligence," *Udacity* (April 9, 2018).
2. Madeline Ngo, "Small Businesses Are Quietly Dying by the Thousands during the Coronavirus Pandemic," *Bloomberg News* (Tribune Content Agency, August 12, 2020).
3. "Gross Domestic Product, First Quarter 2020 (Advance Estimate)," U.S. Bureau of Economic Analysis (April 29, 2020) and "Personal Income and Outlays, March 2020," U.S. Census Bureau and U.S. Bureau of Economic Analysis (April 30, 2020).
4. L. Paul Hood Jr. and Timothy R. Lee, *A Reviewer's Handbook to Business Valuation: Practical Guidance to the Use and Abuse of a Business Appraisal* (New Jersey: John Wiley & Sons, 2011), 26–27.
5. Consideration of subsequent events in a valuation are based on facts and circumstances based on legal guidance under the U.S. Tax Code, regulations to the U.S. Tax Code, and Tax Court decisions.
6. ASA Business Valuation Standards (Herndon, VA: American Society of Appraisers, 2009) and portions of *Uniform Standards of Professional Appraisal Practice* (Washington: Appraisal Foundation, 2020).
7. Shannon P. Pratt and Roger J. Grabowski, *Cost of Capital: Estimation and Applications,* 5th ed. (New York: John Wiley & Sons, Inc. 2014), 70.
8. Ibid., 71.
9. Ibid., 72.
10. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw Hill Companies, 2008), 185.
11. Ibid.
12. Connor J. Thurman and Robert F. Reilly, CPA, "The Property-Specific Risk Premium and Unit Principle Valuations, Part 1," and "Benchmarks to Estimate the Property-Specific Risk Premium Unit Principle, Part 2," *Journal of Multistate Taxation* (forthcoming).
13. Thurman and Reilly, "The Property-Specific Risk Premium and Unit Principle Valuations." CSRP may also be relevant when appraising real property, tangible personal property, and other types of illiquid investments. When applying an investment-specific risk premium in analyses where the valuation subject is not a business interest, similar considerations should be made with regard to the (1) validity of the investment-specific risk premium, (2) legal/statutory limitations on the use of the investment-specific risk premium, and (3) appropriate level of the subject investment-specific premium.
14. Ibid.
15. Ibid.

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