



## 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 potential 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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## Identity Theft and Your Taxes

Identity theft is one of the fastest growing crimes in the United States, with an estimated 9 million victims every year, according to the Federal Trade Commission (FTC, 2011). Identity theft is a type of fraud in which a thief uses your personal information to conduct transactions in your name. Thieves may, for example, use your identity to open or empty bank accounts, obtain credit cards, or take out loans. In addition to fraud directly concerning your finances, thieves can use your information to commit crimes that may affect your taxes.

### Types of Fraud

With your identifying information, an undocumented worker or other individual may use your Social Security number on job applications and employment paperwork. The employer would then report the thief's W-2 wages earned to the IRS using your information, and as a result, when you file your tax return, it could appear to the IRS that you did not report all of your income.

An identity thief may also file a tax return using your name and Social Security number in order to obtain a refund. When you later file your return, the IRS will see that you already filed and received a refund; therefore, the return you submitted would be considered a second copy or duplicate.

### Protecting Yourself

If you receive a notice from the IRS that leads you to believe that your personal information has been used to commit tax fraud, contact the IRS by phone or in writing as directed in the notice. Possible indicators that you may have been the victim of identity theft include statements that you received wages from an employer unknown to you or that more than one tax return was filed in your name. IRS tax examiners can then work with you and other agencies, such as the Social Security Administration, to resolve these discrepancies. It is important to note that the IRS will not initiate a request by e-mail for taxpayer information



in this, or any other, situation. If you do receive such a request, it may be an attempt from identity thieves to obtain your tax information.

In addition to other precautions you may take to help protect your identity from thieves, the IRS recommends that you exercise caution when choosing your tax preparer. Avoid preparers who guarantee results, base fees on a percentage of the amount of refund, or claim they obtain larger refunds than other preparers.

Identity theft can be a financially and emotionally devastating ordeal. For more information about this topic and what to do if you become a victim, visit the FTC's website at [www.ftc.gov](http://www.ftc.gov). ■

## Plan Carefully When Choosing Your Executor

One important decision you will need to make when writing your will is selecting an estate **executor** (or **executrix**). Ideally, your executor should possess the tact of a diplomat and the administrative skills of a professional executive. You may want to choose someone who knows you and your family well enough to faithfully carry out your wishes, but who also has the necessary objectivity to handle any conflicts that may arise.

Although any person you trust can be your executor, many people

choose a spouse, close friend, or associate, who may also be a **beneficiary** of the estate. Large estates may require two executors: a personal representative to interpret your wishes and a professional representative or institution, such as your attorney or a bank, to make business or financial decisions, pay taxes, and maintain records.

An executor's role is to carry out the terms of your will. This process begins with identifying and determining the value of the assets in your

estate. (Trusts, life insurance policies, pension plans, and some types of jointly owned property may fall outside the executor's responsibility.) Certain assets may require a valuation by an **appraiser**, whose fee is generally paid from your estate's assets, as are expenses for lawyers, accountants, and other professionals. An executor is also responsible for paying your debts from the assets of your estate, filing tax returns, and distributing any remaining assets to your heirs.

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## Disability Income Insurance: Some Features Say It All

Prospective insurance buyers may often get confused about **disability income insurance** because the features and benefits can vary widely from one policy to another. Essentially, there are a few key elements that could make a difference when you choose a policy. If you are in the market for disability income insurance, here are some points you may want to consider:

### Definition of “Total Disability.”

Does the policy define total disability as a condition during which you cannot perform the duties of your *own* occupation or *any* occupation? A policy that refers to your own occupation generally pays benefits if a sickness or injury prevents you from working in your occupation, even if you could work in a different job. A policy that refers to any occupation typically pays benefits only if you are unable to perform *any* job: your own job, a lower-paying job, or a job in a new occupation.

**Duration of Benefits.** Even if you have to choose a smaller benefit amount to keep the premiums affordable, look for coverage that protects you until age 65. Note that there are policies available that offer benefits

only for a limited period (such as a maximum of two or five years), and the nature of your occupation may affect the duration of coverage.

**Amount of Coverage.** Policies usually set a limit on the percentage of income you can insure—usually 50% to 70% of your total gross earnings. If you have an employer-provided plan that offers only limited group coverage, you may want to supplement this coverage with individual disability income insurance.

**Elimination Period.** The waiting or “elimination” period is the amount of time you must be disabled before disability benefits begin to be paid. While a shorter waiting period requires a higher premium, a longer waiting period may mean you will have to rely on your savings until benefits begin. Keep in mind that the waiting period is determined when a policy is *issued*, not when you sustain the disability.

**Taxation of Benefits.** Benefits may be tax free if you pay the premiums using *after-tax* dollars. If you receive benefits under an employer-provided plan, they may be taxable if the premiums are paid with pre-tax dollars or the employer pays the

premium. Consult your tax professional for specific guidance on this matter.

### Partial or “Residual” Coverage.

After a serious disability, many people are able to return to work only on a part-time basis. Partial or “residual” benefits allow you to receive partial disability benefits, as well as your part-time income, until you fully recover. Without this feature, your benefits may stop as soon as you return to work, even if only part time.

**Portable Coverage.** Policies that allow you to carry your coverage from one job to another have an obvious advantage. Examples include coverage from a professional association providing portable coverage that is not tied to your place of employment, as well as any individual disability income policy that you might purchase independently.

It is important to determine the amount of coverage needed that best suits your situation before shopping for a policy. Review your insurance coverage and needs on a regular basis with a qualified insurance professional to make sure that you are adequately protected. ■

## plan carefully when choosing your executor

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Throughout this process, detailed records must be kept. Most **probate courts** will require a comprehensive, detailed account of all money received, spent, or held by your estate.

If you die *without* a will (**intestate**), the court will appoint an administrator to perform the executor’s duties. Without a designated relative or beneficiary, the appointee may or may not be someone you would have named.



When choosing an executor, be sure that the person is willing to accept the responsibility. You may also wish to choose an alternate executor to serve should your initial choice be unable to do so. If you have not yet chosen your executor, consider doing so as soon as possible to minimize potential complications later. ■

## valuing a closely held business

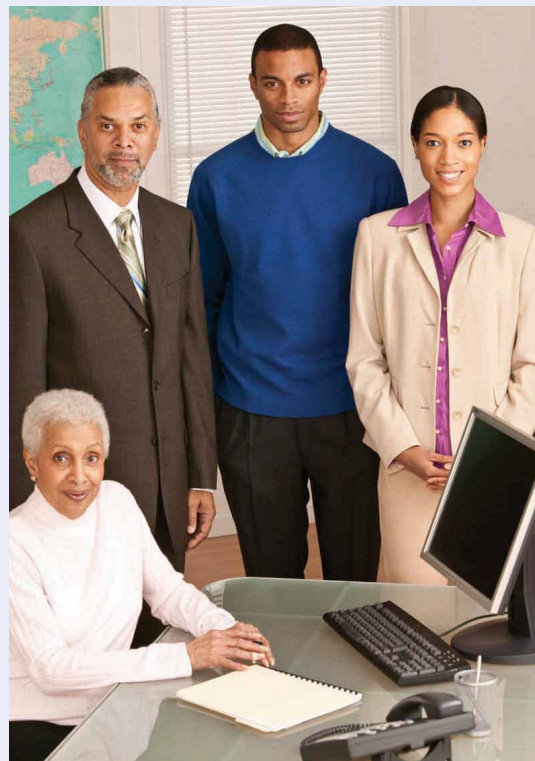
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- 4) Profit and loss statements must be scrutinized to determine the company's earnings history. While the Internal Revenue Service (IRS) may require the past five years of profit and loss statements, for example, the agency generally will not respect 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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