LIFE ADVANCED MARKETS

Buy-sell valuation methods

This information is intended to evaluate some of the more common valuation methods used in a typical buy-sell agreement, as well as provide a few hypothetical examples of which valuation methods might fit a particular type of business. Share this reference material with your client and their attorney to initiate the creation of a buy-sell agreement tailored to their business needs.

This document is intended as general information only and may be provided to the client's attorney for consideration. It is not adapted to the specific circumstances or objectives of any individual client, nor to meet the local requirements of any particular jurisdiction, and shall not be represented as such to any client or their attorney. All legal documents must be prepared only by a licensed attorney, observing all formalities required under the relevant jurisdiction.

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Analysis of buy-sell valuation methods

Planning objectives for any valuation method chosen:

- Establish the valuation method when the agreement is created – not when a triggering event has occurred.
- Method should be fair to both buyer and seller.
- Method should be reasonable and customary considering the type of business involved.
- Method should be manageable and easy to understand.
- Method should establish the fair market value (FMV) of the interest at the date of sale (less any applicable discounts). Generally, a fixed price as of the date the agreement is signed is not sufficient for transfer-tax purposes.

Method	Advantages	Considerations	Examples where this method may be used
Book value	May be simple to calculate (e.g., stated assets minus liabilities).	Not often used for buy-sell agreements. No universal definition, so it's important to define "book value," the accounting method used, and the date on which valuation is made. Method could be manipulated to favor either the seller or the buyer.	Asset-holding company, real estate or development business, where mainly assets (not earnings) determine value.
Agreed-upon value	Simple, easy to understand. Minimizes potential for dispute among seller and buyer. Minimizes accounting and appraisal fees. Stated price makes funding the agreement with life insurance easier because amounts of life insurance need can be readily determined.	Must be periodically revised. May quickly become stale if not regularly updated. Value may not be persuasive for gift tax or estate tax purposes.	Businesses that own unique assets, or very few (but highly valued) assets, especially assets which may depreciate slowly or even appreciate. Examples may include a classic car business, jewelry business, or antique dealer.
Appraised value	Easy to understand. Generally more accurate valuation method. May more accurately reflect current market conditions and sales of similar businesses which may have occurred.	Fee charged by appraiser(s) makes this method more expensive. Use of an independent appraiser may lead to disputes between seller and buyer, depending on who chose the appraiser.	May be used by businesses that have mostly tangible assets. Examples include manufacturing and real estate companies. May be less useful for service companies or technology companies, which typically have more intangible assets.
Formula valuation	Can be more accurate. Can be tailored to an earnings factor for a specific industry.	More complex valuation process. May be more difficult for individual buyers and sellers to understand. May be more difficult for owner(s) to understand the value of their ownership interest at any given time.	Any business where the seller wants to know the value based on risk versus reward.