What It's Worth

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Valuation Training for Appeals Officers Course Book

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Department of the Treasury
Internal Revenue Service

Valuation Training for Appeals Officers

Coursebook

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Internal Revenue Service

Mission

The purpose of the IRS is to collect the proper amount of tax revenues at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency and fairness. To achieve that purpose, we will:

Encourage and achieve and highest possible degree of voluntary compliance in accordance with the tax law and regulations;

Advise the public of compliance and the causes of noncompliance;

Do all things needed for the proper administration and enforcement of the tax laws;

Continually search for and implement new, more efficient and effective ways of accomplishing our Mission.

Appeals Mission

The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.

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*Not included in this posting

Preface

Valuation issues permeate many areas of the tax law creating controversies which appeals officers are called upon to resolve. Some of the valuation areas are:

- Valuation of assets at date of gift or death for gift and estate tax purposes.
- Valuation of assets contributed to charitable organizations.
- Valuation of assets lost due to casualty
- Valuation of assets distributed out of a corporation upon a taxable liquidation after the 1986 Tax Reform Act repeal of the "General Utilities Doctrine."
- Allocation of the cost of assets in a bulk purchase between depreciable and nondepreciable assets such as land and goodwill.

The course is intended for appeals officers with little or no valuation experience. Most new appeals officers come from Examination and have considerable auditing and report writing experience. You will learn and discuss the basic valuation concepts and their application to specific factual situations in order to reach high quality resolutions of issues.

This course deals with fair market value and the generic willing-buyer/willing-seller definition. It is important to note that we will not cover such specialized areas as estate tax special use valuation under IRC § 2032A or the estate and gift tax special valuation rules of IRC §§ 2701 through 2704.

This course consists of 56 hours of classroom training. Your instructors have extensive experience in valuation issues. The lessons were written primarily by appeals officers who have years of experience in resolving valuation issues in the areas about which they wrote. It was written with sufficient detail to help you understand appraisal reports written by experts from within and outside the Service. This coursebook, the handout package, and the addendum to the handout package contain references to law, regulations, rulings, and court cases. In some instances, they contain complete copies of important court decisions. These references should be helpful to you in the future when you have valuation issues.

Lesson 1

Introduction to Valuation

Contents

Introduction

The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.[i]

In accomplishing this mission, appeals officers have the objective of granting prompt appeals conferences, reaching high quality decisions and achieving a satisfactory number of agreed settlements.

The importance of settling valuation cases has been frequently underscored by the courts. In Messing v. Commissioner, the Court said:

Extract

Messing v. Commissioner, 48 T.C. 502 (1967), page 512

Too often in valuation disputes the parties have convinced themselves of the unalterable correctness of their positions and have consequently failed successfully to conclude settlement negotiations – a process clearly more conducive to the proper disposition of disputes such as this. The result is an overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement. * * *

*   *   *   *   *

Later, in Buffalo Tool & Die Manufacturing Co. v. Commissioner, the Tax Court said:

Extract

Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441 (1980)

*   *   *   *   *

* * * As the court repeatedly admonished counsel at trial, the issue is more properly suited for the give and take of the settlement process than adjudication. * * * The existing record reeks of stubbornness rather than flexibility on the part of

> both parties. * * * We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort and money by the parties and the Court – a process not likely to produce a better result. Indeed, each of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach. * * *

* * * * *

As appeals officers, we should always strive to settle cases. This is especially true with respect to valuation cases because of the judicial distaste for such issues as reflected in <u>Messing</u> and <u>Buffalo Tool & Die</u>.

Objectives

At the end of this lesson, you will be able to:

1. Define the concept of fair market value (FMV).

2. Define the market, income and cost methods of valuation.

Fair Market Value

Fair market value (FMV) is defined as "the price at which the property would change hands between a **willing buyer** and a **willing seller**, neither being under any compulsion to buy or sell and both having **reasonable knowledge** of the relevant facts. (Emphasis added)"[ii] We will discuss how the concept of FMV applies to the valuation of real estate, art objects, closely held corporations, and other forms of property.

The above definition of fair market value, which falls under the topic of charitable contributions in the regulations, applies to income tax and estate and gift tax cases. The definition of fair market value for estate tax purposes is at Treas. Reg. § 20.2031-1(b) and, for gift tax purposes is at Treas. Reg. § 25.2512-1. Both definitions are the same.

These definitions <u>should</u> be the same regardless of the tax implications of the issue. In <u>Anselmo v. Commissioner</u>,[iii] the Court, in applying this definition of fair market value in a charitable contributions case, held that there should be no distinction between the measure of fair market value for estate and gift tax purposes and charitable contributions under the income tax law.

Similarly, Rev. Rul. 68-609,[iv] (at **Exhibit 13-2** [not included in this posting]) provides the general approach, methods and factors outlined in Rev. Rul. 59-60.[v] (This is an important ruling in valuation and is covered in Lesson 7. The ruling is reproduced in that Lesson as

Exhibit 7-1.) In addition, Rev. Rul. 65-192 broadened the applicability of Rev. Rul. 59-60 by making its provisions relevant in determinations of the fair market value of business interests of any type and intangible assets for all tax purposes.

The definitions of FMV are found in the regulations, administrative pronouncements and judicial precedent. In addressing any determination of fair market value, you should apply the standard willing buyer/willing seller test unless you find a specific authority to the contrary.

The following list of income tax transactions, where valuation is relevant, is by no means exhaustive:

- Bargain purchases;
- "Boot" in tax-free transfer;
- Casualty losses;
- Charitable contribution of property;
- Compensation received in property;
- Dividends received in property;
- Employee stock options;
- Exchange of properties;
- Foreclosure of mortgaged property;
- Incorporation of business;
- Insolvent corporation capitalized;
- Inventory valuation;
- Liquidation, property received by stockholder;
- Lump sum acquisition of various properties;
- Rents received in property;
- Recapitalization;
- Residence converted to rental property;
- Stock rights; and

- Tax shelters.

We will now analyze the elements of the definition of fair market value.

Price at Which Property Would Change Hands

What is being defined is the hypothetical "sale" price. Obviously, an actual sale of the property would be the best indicator of value. If none is available, you must make a reasonable estimate of the hypothetical sale price. The factors that go into estimating this sale price are set out in the definition of fair market value.

Generally, the hypothetical sale is considered to be a sale for cash. The correct standard for valuation for our purposes is the amount the asset would bring in a cash sale. In the traditional form of financing, such as a standard bank mortgage transaction, the seller receives cash even though the buyer is making installment payments.

In recent years, particularly in the real estate area, various forms of owner financing have arisen, such as purchase money mortgages, whereby the seller receives payments in installments. In such a situation, the price will be artificially inflated to compensate the seller for the greater risk assumed. It is important to remember that the concept of valuing is based on a cash or cash equivalent price. The additional increase or decrease in value resulting from special financing is not considered. See Morris v. Commissioner.[vi]

Between a Willing Buyer and Willing Seller

What exactly is a willing buyer or seller? Basically, it is a state of mind – so this hypothetical sale starts out with someone who wants to buy the property and someone who wants to sell the property. Why is this important? Because if the buyer does not want to buy, and the seller does not want to sell, either no sale would take place, or the sale that did take place would not be representative of fair market value.

Please note that the presence of a willing buyer and a willing seller is different from the absence of a compulsion to buy or sell. The difference is one of degree.

The willing buyer and willing seller are hypothetical persons, not actual persons. See United States v. Simmons and Estate of Bright v. United States.[vii] Accordingly, it is irrelevant who the real seller or buyer are. The important thing to remember is that valuation must consider **both** the willing seller **and** the willing buyer. You should not focus on the willing buyer side of the valuation equation while ignoring the willing seller side (or conversely focus on the seller while ignoring the buyer). See Moore.[viii]

Neither Being Under Compulsion To Buy or Sell

A sale under which one party or the other would be compelled would not be representative of fair market value. If the buyer is compelled to buy, the price would be artificially high, and if the seller is compelled to sell, the price would be artificially low. An example of this would be a foreclosure sale, where the seller is compelled to sell, causing an artificially low value.

There are many cases in which the Court forbids valuation based on compulsion. Bright is just representative.

Both Having Reasonable Knowledge of
Relevant Facts as of the Applicable
Valuation Date

The hypothetical sale must assume that both buyer and seller have a reasonable knowledge of the facts about the property. If not, the sale is not a valid representation of value.

Example 1

> A buyer is informed of the fact that property for sale has valuable oil reserves; the seller is not. The property is sold at a much lower value due to the seller's lack of information. Is this a sale at fair market value as defined in the Regulations?

Our hypothetical sale presupposes that both the buyer and the seller have reasonable knowledge of the relevant facts on the valuation date. What happens when additional facts come out after the valuation date?

Example 2

> In the example above, there is also a geological survey which shows the possibility that oil reserves exist on the subject property. Does this fact affect the value? What about a test drilling on the property that showed valuable oil reserves did exist on the property? Does the predictability of a fact affect value?

The Simmons case cited earlier contains a good discussion of the definition of reasonable knowledge of relevant facts. The proper standard of reasonable knowledge is not what is actually known as of the valuation date; rather, it is proper to consider facts that are discovered through reasonable investigation, as long as such facts existed as of the valuation date, even if they were not actually know at that time.

In Estate of I.W. Baldwin, the Court said:

Extract

> Estate of I.W. Baldwin v. Commissioner, T.C. Memo 1959-203, (1959), page 946
>
> *   *   *   *   *
>
> Even if the executors were totally ignorant of the claim, we do not agree that it would for that reason be without value. An estate may possess many assets, tangible or intangible, of which the deceased's representative or even the decedent himself may be unaware, and which may not become apparent until the lapse of a substantial period of time after death. Such property is, for that reason, no less an asset of the estate, nor can it necessarily be said to be valueless at the date of

death. This is particularly true where, as here, the asset is one which by its nature is discoverable in the ordinary course of administration of the estate.

* * * * *

While it is permissible to consider the facts unknown but discoverable as of the valuation date, true subsequent events unknown at the valuation date are another matter and more controversial. In Morris, the Court made it clear that subsequent events actually occurring after the valuation date may not be considered unless reasonably foreseeable as of the valuation date. See Ithaca Trust v. United States, Estate of Jephson v. Commissioner, and Cowyers v. Commissioner.[ix]

Marketplace

The hypothetical sale we discussed above must take place somewhere, and that "somewhere" is defined by the regulations as the marketplace within which that item is most commonly sold to the public.

Treas. Reg. § 20.2031-1(b) states "…Nor is the fair market value of an item of property to be determined by the sale of the item in a market other than that in which such item is most commonly sold to the public. Thus, in the case of an item of property * * * which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item would be sold at retail."

The sale to the public refers to sale to the retail customer who is the ultimate consumer of the property. The retail customer is not necessarily the individual purchaser. At issue in Anselmo, for example, was the valuation of uncut gems. Retail jewelers were considered to be the ultimate consumers of uncut gems. The uncut gems were consumed in the process of manufacturing items of jewelry.

The concept of the marketplace includes consideration of the location of the marketplace, as well as the type of market, that is, the wholesale or the retail market.

Fact Versus Law

In Messing, cited earlier, the Court described valuation as a question of fact with the case law providing little precedential value. That is correct, as far as it goes, but it is also true that the definition of value – the criterion that should be used in determining value – is a question of law. See Powers v. Commissioner and L.B. Maytag v. Commissioner.[x]

In Maytag, the Court said:

Extract

L.B. Maytag v. Commissioner

* * * * *

> The taxpayer also directs our attention to the rule that the question of the proper criteria or criterion to be employed in determining the market value of property transferred as a gift is a question of law reviewable in the court of appeals. The criteria or criterion to be employed in a proceeding of this kind in determining the value of gifts is a question of law, and if it appears on review that the Tax Court employed the wrong or insufficient criteria or criterion is arriving at its determination of value, to the prejudice of the taxpayer, the decision will be reversed * * *

* * * * *

Accordingly, the consideration of any valuation case would ensure that both sides, including their respective appraisers, if any, are employing the correct definition and criteria for determining fair market value. No case is stronger than its weakest link and if the wrong standard of valuation is applied, the conclusion will be defective.

Basic Valuation Methods

Historically, the process of valuation began with the appraisal of real estate. Therefore, many of the concepts and procedures are put in terms that involve real estate. The concepts and procedures will apply to all types of property, though not all methods are appropriate in every case.

There are three basic valuation methods, the market approach, the income approach and the cost approach. Subsequent lessons will cover these methods in greater detail, so the discussion in this lesson will be fairly basic.

Market Approach

The market approach, also known as the market comparison approach, values property on the basis of the prices of actual sales of similar (comparable) properties. An arms-length sale of the property at issue on the valuation date, would normally be determinative of its fair market value, and would also, with few exceptions, eliminate the need to arrive at value by other means. Where the subject property has not been the subject of an arms-length sale, the next best indication of value would be the price at which a reasonably comparable piece of property was sold. See Rev. Proc. 79-24.[xi]

The market approach is based upon the assumption that a reasonably prudent person will not pay more to acquire a property than it would cost to acquire a comparable substitute property. Conversely, a prudent seller will not ordinarily sell a property for less than other sellers have been able to get for their similar properties.

It is extremely unlikely, if not actually impossible, that an exact comparable can be found. It is sufficient to consider sales of similar property, making adjustments for differences that exist between the comparables and the property to be valued. When using the market approach, as many comparables as possible should be used.

While individual sales may deviate from the normal pattern of the market, an adequate number of sales will tend to reflect the pattern of buyers and sellers. The pattern of a sufficient number of sales is a good reflection of fair market value. If there is a sufficiently active market, a pattern will usually emerge. A good rule of thumb is to use enough comparables to develop a definite pattern. Most buyers and sellers will consult the market in their negotiations so that a sales pattern will often tend to be self-perpetuating.

Appraisers should always analyze comparable sales, if available, since such sales reflect the informed judgment of those active in the market place.

This approach is particularly useful in the valuation of unimproved real estate. Controversies generally arise over the degree of the adjustment required to make given properties as comparable as possible. One essential criterion that must be applied when the comparable sales approach is being used is the invalidity of subsequent events. There is a very real danger in relying on sales of similar property in arriving at an indication of market value, which have occurred after the basic valuation date.

The facts surrounding such post-valuation date events could not have been known on that date, and consequently are technically and legally inadmissible as factors to consider in reaching an opinion. These data can, however, be used as proof of conclusions based on prevaluation-date sales or other data. A good example of the application of the market approach is Estate of John C. Mitchell, 27 T.C.M. 1568, T.C. Memo 1968-297.

In applying the market approach, it is vital to insure that the comparable sale that is selected fully conforms to the proper definition of fair market value. A comparable sale should not be used unless it represents a transaction between a willing buyer and willing seller. As discussed earlier, neither should be under any compulsion to buy or to sell and both should have reasonable knowledge of relevant facts.

Income Approach

In this approach, the projected net income, either before or after depreciation, interest and income taxes, is estimated and then capitalized at selected rates. The income flow is capitalized at a rate which is desired or which can be anticipated as a return on the investment.

Anticipated Income

The first step in applying the income approach requires a determination of the anticipated income from the asset. Probably the most common method for determining the anticipated income is to use the actual income figures for the previous years, often the prior three to five years.

If the prior years' figures are used, it is necessary to factor out nonrecurring items because it cannot be assumed that the item will repeat. The income capitalization approach is based upon the assumption that the asset will produce income on an on-going basis; therefore, the use of an item of income or expense that cannot be expected to recur on a regular basis would create a distortion.

Similarly, the appraiser must determine whether to average the prior years' figures or to place greatest weight on a recent year or even to combine both the averaging approach and the adjustment of recent years under a weighted average approach. There is no hard and fast rule here, but in general, the averaging approach is preferred when income fluctuates while the weighted average of later years' figures is preferred when a trend is reflected.

It should be noted that the income approach is based upon the earnings capacity of the property. If actual income is less than capacity, for any reason, or expenses are greater than they should be, then adjustments must be made. An example of this situation would be a business that is earning less than it could because of poor management. Another example would be property not being used at its highest and best use. Conversely, if it can be anticipated that income will drop, adjustments should be made.

Capitalization Rate

The second step is the determination of the capitalization rate. The capitalization rate is the anticipated rate of return that the investor desires to receive, considering the nature of the property and the risks involved, expressed as a percentage. For example, if, under the particular facts, the investor desires to receive a ten percent rate of return, the capitalization rate would be ten percent. The anticipated net income is then divided by the capitalization rate to derive the value.

There are several methods for developing the capitalization rate. One approach is to compare the selling prices of comparable properties which derive income in a similar manner. The price of the comparable divided by its income is the price/earnings (P/E) ratio.

PRICE/EARNINGS RATIO

$$\frac{\textbf{Price of Comparable}}{\textbf{Income of Comparable}} = \textbf{P/E ratio}$$

The capitalization rate is the reciprocal of the price/earnings ratio (E/P).

CAPITALIZATION RATE

$$\frac{\textbf{Income of Comparable}}{\textbf{Price of Comparable}} = \textbf{Rate}$$

In developing the capitalization rate through the use of comparable properties, the same kind of care must be used in selecting the comparables that are required under the market approach.

A capitalization rate can also be developed by determining a "safe rate" for conservative investments such as Government securities or certificates of deposit and then adding to the safe rate, factors for risk and/or liquidity. As an example:

CAPITALIZATION RATE

Safe Rate: **6.5%**

Risk Factor:	**2.0%**
Liquidity Factor:	**<u>2.0%</u>**
CAPITALIZATION RATE	**10.5%**

(The figures reflected in this example are chosen solely for illustration and are not an opinion that the rates are correct for any particular case.)

There are other methods for developing a capitalization rate (which will be covered later in the valuation of specific assets). At this point, it is most important to remember that great care must be taken in determining the capitalization rate to be used. Very small changes in the capitalization rate can generate large changes in the determined value.

The income approach can be used for any income producing assets; its use is particularly common for commercial and/or rental estate and for corporate stocks or other business interests.

Cost Approach

The cost approach values property by determining the reproduction cost less the observed depreciation. It can be useful in valuing special-use real estate, for example. Because accurate cost and depreciation data is very difficult to get, this approach is difficult to use and most subject to error. You will probably face the issue of determining whether reproduction cost less observed depreciation is the correct approach.

This approach requires an estimate of the cost of replacing a structure (including the cost of the non-productive investment of funds during the construction period), an estimate of the depreciation and obsolescence that has taken place in the existing structure, and an appraisal of the land involved. When estimating replacement costs, appraisers generally use engineering manuals to get cost data. When there are wide differences of opinion between appraisers, then engineers, architects, contractors or others may be required to properly develop costs. This approach requires great skill on the part of the appraiser and the cost and depreciation estimates required in the approach may lead to controversy. Be aware that there are publications which list reproduction cost by grade, type of building and location, and which can be used as references.

The cost method is relatively rare. It does tend to set a ceiling on value, based on the proposition that a prudent investor would not spend more to acquire an asset than it would cost to reproduce the asset. The weakness of the cost approach is that while the cost of reproducing the asset can generally be objectively determined, the accrued depreciation tends to be highly subjective and difficult to measure, as depreciation here is not defined in the same manner as depreciation for income tax purposes. Depreciation (and obsolescence), for purposes of the cost approach, includes physical, functional and economic considerations which can be difficult to measure and are, therefore, subjective.

Depending on the particular item, it may be possible to use more than one method for a particular asset. Whatever approach is used, care should be taken to insure that such approach is actually used in the market. For example, in <u>Estate of Frank Fitte</u>, 52 T.C.M.

567, T.C. Memo 1986-452, the Court rejected the income capitalization method because it was not considered by prospective purchasers of the type of asset being valued.

Summary

There are five truisms that anyone approaching the subject of valuation should be aware of as a frame of reference:

1. Each valuation case is unique. Little or no precedent is to be obtained from the earlier cases. The cases are rarely on point and a significant differentiation of the facts can usually be made.

2. In valuation there are no absolutes and there are only general guidelines to which individual judgments must be applied.

3. There is no irrefutable "right" answer.

4. Experts will differ.

5. There are available substantive aids and/or methods which are generally recognized and accepted by the appraisal profession and the Courts.

Remember that these valuation methods will be covered in more detail in subsequent lessons, each being tailored to the individual property being discussed. In the next lesson, you will learn how to get assistance with these cases from the Service and from outside the Service.

Lesson 2

Service Concepts and Procedures

Contents

Introduction

Some appeals officers have had experience resolving simple valuation issues such as charitable contributions of used household goods or small casualty losses. They have resolved these issues by using data developed locally by the examiners or themselves, by reviewing the information furnished by the taxpayers and by reading court cases to see what judges have allowed as adequate substantiation.

This lesson focuses on getting expert help on the more complex cases with serious disagreements. These cases often have expert appraisals by the taxpayer's representatives. This lesson will show you how to obtain your own expert help from within the Service or from outside the Service.

In this and subsequent lessons, we will be doing selected readings in *Valuing a Business, The Analysis and Appraisal of Closely Held Companies,* by Shannon P. Pratt.[xii] We will refer to the "Pratt text" when directing you to a reading assignment.

Objective

At the end of this lesson you will be able to explain when and how to obtain expert help in resolving valuation issues.

Requesting Valuation Assistance

You have three choices when you think you need formal valuation assistance. These choices are:

1. Examination appraisers, engineers and financial analysts available in each region.

2. Appraisers, engineers and financial analysts from the National Office.

3. Outside fee appraisers, engineers and other experts.

Engineering Groups in Each Region

B**ackground**

Some cases you receive will have valuation issues and will include reports from an engineering group from Examination. These engineering groups include engineers in the fields of mining, timber, geology, petroleum, industrial and general. They also include real estate appraisers and financial analysts. Not all fields are represented in all regions.

There are engineers and appraisers in key districts throughout the country. The key districts and associate districts are listed in IRM 42(16)1.2. IRM42(16)0 is included at the end of this lesson as **Exhibit 2-1** [not included in this posting].

Many of the engineers and appraisers are expert witnesses and are qualified to testify before the Tax Court and District Court.

Request Procedures

You may request assistance from the engineering groups for an informal or formal appraisal or for a critique of a taxpayer's appraisal. These requests are made through your chief to the district where the engineers are located. Their guidelines are in IRM 42(16)1 and **Exhibit 2-1** [not included in this posting]. Some districts require Form 5202, Request for Engineering Assistance (**Exhibit 2-2** [not included in this posting]), or a memo explaining the need.

Office of Appraisal Services in National Office

Types of Services

In those cases involving business valuation, real estate valuation and art valuation issues which require expertise not available locally within the Service, you may request assistance from the Office of Appeals Services, National Office.

Here are some examples of areas where assistance is available:

1. valuation of closely held securities, partnerships, proprietorships and other business interests;
2. valuation of patents, copyrights and other intangible assets;
3. determination of discounts for blockage or "restricted" securities;
4. valuation of art objects and other cultural property;
5. valuation of real estate;
6. valuation of timber, mining, oil and gas properties;
7. allocation of a lump sum among assets acquired by purchase;
8. determination of "reasonable" compensation;
9. determination of accumulated earnings under IRC § 531;
10. a critique of the taxpayer's appraisal.

The Office of Appraisal Services consists of two sections. The Financial/ Real Estate Section is composed of financial analysts and real estate appraisers. The Art Advisory Services Section has art experts and access to the Art Advisory Panel. All of the appraisers in the Office of Appraisal Services are highly qualified experts who have testified in the courts regarding valuations.

Exhibit 2-3 [not included in this posting] is from IRM 8112, Assistance from the Office of Appraisal Services. Besides the general appraisal request procedures included in this handbook, Chapter 600 also includes detailed instructions for requests from the Art Advisory Services Section.

Although there are no minimum criteria, you may seek assistance in those cases in which the valuation issue:

1. is complex, unique or beyond the expertise available locally within the Service, and which usually involves a substantial amount of tax,

2. has an impact on a large number of taxpayers, or

3. is one in which the taxpayer has engaged the services of an expert and you deem it appropriate to secure another expert's opinion.

Request Procedures

You are encouraged to call the Director, Office of Appraisal Services, to informally discuss a valuation problem to determine the type of assistance required and whether a formal request is needed. Before you all, refer to the Appraisal Services Handbook described above (**Exhibit 2-3** [not included in this posting]). It contains some of the usual data needed for requests for appraisals of closely held securities, intangibles, real property and works of art.

Request National Office assistance as early as possible so they may be of maximum assistance. The National Office appraiser may request more information from the taxpayer that you are responsible for obtaining.

To request valuation assistance, you should prepare a memorandum to the Director, Office of Appraisal Services, C:AP:AS, describing the facts of the issue and transmitting all of the appropriate supporting documentation. This documentation that accompanies your request varies with the type of services requested.

Use of Outside Appraisal Services

In some cases you and your manager may want to have an appraisal from an independent, non-IRS appraiser. This is often the case when the taxpayer has hired an independent appraiser who is highly qualified and whose court testimony could not be easily rebutted by a valuation prepared by an IRS appraiser, who might be viewed as biased by the court. Outside appraisers are also used in specialty areas in which the IRS does not have the required expertise.

These appraisals are often relatively expensive and require approval at the regional level. In nondocketed cases, the Assistant Regional Commissioner (Examination) provides the funds for outside appraisal services. You should follow the procedures and format described in the regional commissioner's memorandum.

In docketed cases, District Counsel provides the funds for engaging outside appraisal services with the intent of using the outside appraiser as an expert witness during litigation, if the case is not settled. Because of this, District Counsel must participate in and approve the selection of an outside appraiser in all docketed cases. You should also request the participation of District Counsel in the selection and approval of an outside appraiser in those nondocketed cases which have a strong likelihood of not being settled in nondocketed status.

Uniform Standards

Neither the Internal Revenue Code nor the regulations provide any uniform guidelines for appraisals other than the definition of fair market value. We discussed this information in Lesson 1. It is also defined in IRC § 170, pertaining to charitable contributions, as well as Rev. Proc. 66-49.[xiii]

IRC § 170(a)(1) instructs the Treasury to provide regulations to "verify" the amount of a charitable deduction. Treas. Reg. § 1.170A-13 provides the rules for substantiation which became effective for contributions made after December 31, 1984. The regulations provide that a taxpayer, other than a regular corporation, must obtain a written appraisal from a qualified appraiser and provide an appraisal summary with the return on which a contribution is excess of $5,000 is claimed. This summary is Form 8283, *Noncash Charitable Contributions* (**Exhibit 2-4** [not included in this posting]). On Form 8283, the signatures of the donee, the donor and the appraiser are required. A "qualified appraiser" under these regulations is one who:

1. holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

2. is qualified to make appraisals of the type of property being appraised based on background, experience, education and membership, if any, in professional organizations;

3. does not charge fees for the appraisal based on a percentage of the value of the property; and

4. is not a party to the transaction nor related to the donor or donee.

Although the Code and regulations do not provide any uniform standards, there is currently a "quiet revolution" occurring in the appraisal industry in the U.S. This is due to dissatisfaction by several appraisal groups and the Congress over appraisals which were allegedly "made to order" in the savings and loan and the banking industries. Many of these appraisals were weighted to support loans which were in excess of true fair market value.

In 1987, the nonprofit Appraisal Foundation was formed by eight appraisal organizations in the U.S. (More on the primary organizations in Lesson 4.) The foundation's main purpose was to develop and implement uniform standards in appraisals of real estate, personal property and businesses, regardless of whether the appraiser was designated by an organization. The foundation's first standards were approved in 1989, as the "Uniform Standards of Professional Appraisal Practice" and were later adopted and recognized throughout the U.S. as the generally accepted standards of appraisal practice by the member organizations.

FIRREA

In 1989, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). One provision of FIRREA was to create the Resolution Trust

Corporation which was involved in taking over and disposing of hundreds of insolvent savings and loan institutions. One of the most far-reaching provisions of FIRREA requires the use of licensed and trained appraisers subject to ethical and uniform standards of appraisal for real estate, personal property and business. The law also requires states to enact laws **at least** as strict as the Federal law.

In late 1991, about 30 states had the appraisal standards law and the rest were in the process. Most states had appraisal regulatory agencies by September 1991. The effective date for the FIRREA appraisal standards was initially June 30, 1991 and then extended to January 1, 1992. However, the effective date of the various state's regulations is not yet known. Some states may have effective dates as early as 1992, but it may take several years to get training and testing fully in place.

Licensing

As a result of the standards and the laws discussed above, licensing for real estate appraisers will soon be required in all states. The licensee will be known as a "Certified Appraiser," a "Certified Residential Real Estate Appraiser" or some other name, depending on the state law. To be licensed, the appraiser must pass a written test, have had certain education and experience, maintain expertise by attending continuing professional education and pay annual fees to the state board.

The law **does not** allow for "grandfathering," whereby a person currently an MAI (Member Appraisal Institute) or any other designation would automatically become a Certified General Appraiser. **All** applicants must have the required training, pass the written tests and maintain certain levels of continuing professional education. Many state licensing laws require all appraisers to be prepared by a licensed, certified appraiser.

What do these new licensing laws mean to us in Appeals? Will we accept appraisals prepared by an unlicensed appraiser? Will our own staff of appraisers have to be licensed to comply with the new laws?

At this time, we do not know if nonlicensed appraisals will be accepted nor if our internal appraisers will have to be licensed. Certainly, if a taxpayer or representative presents an appraisal by an appraiser who is a designated or candidate member of one of the recognized appraisal organizations or who is a state licensed appraiser, you should consider it.

In a recent Tax Court case, <u>Utilicorp United Inc. and Subsidiaries v. Commissioner</u>, 104 TC 32 (1995) addressed this issue by concluding that a valuation report prepared for income tax purposes by appraisers who were not licensed to appraise real estate in the state in which Utilicorp was located, was admissible as evidence in the Tax Court because "the report was not prepared for a consumer, in the sense intended by the state legislature, or in connection with a federally related transaction." The Tax Court made a similar finding with the testimony of appraisers.

Which Service to Request

In some cases, the examiner has already requested an appraisal and it is in the file when it is assigned to you. You may decide that it is inadequate when compared to the report the taxpayer has secured. You may have a difficult time choosing which of the three options to use: the region, the national office or outside engineers and appraisers.

Some deciding factors you may consider are:

1. **Specialty area of expertise:** Perhaps the specialty is available only in the National Office or only from an outside appraiser.

   Example 1

   The file includes a district appraisal of farm land plus an appraisal from the taxpayer's CPA. The land is owned by a corporation of which the taxpayer (decedent) owned only 15%. The CPA claims a 60% minority discount which is not addressed in the IRS appraisal because our appraiser had expertise in real estate valuation but not in discounts. If you think the case will be unagreed in Appeals, you should request that District Counsel arrange for a Service financial analyst, an outside appraiser or other qualified expert to evaluate the minority discount.

2. **The litigating value of the appraisal:** If you think the case may go unagreed to court, select the appraiser that will have the strongest credibility in that court. This is often a matter of assessing the credentials of the appraiser, the quality of the appraisal itself, and how well the appraiser handles himself or herself when testifying.

3. **Time constraints:** If you have a court calendar date set, you may not have enough time to go through the procurement processes to get an outside appraiser. Your case may not be a high enough priority to be worked by the in-house appraisers in a short time span. Informal telephone calls can often answer these questions of timing. This is normally handled by District Counsel rather than Appeals.

4. **Early in the case:** The request for assistance should be made as early as possible in order to avoid future timing problems on the case. Often you can identify the need for assistance from your first review of the file when it is initially assigned to you.

Summary

Many valuation cases will already contain an appraisal by a district engineer. If not, you may request one from the district, the national office or an outside appraiser. The primary factors you should consider in deciding which one to request are:

1. complexity and impact of the case,

2. the litigating value of the appraisal,

3. budget restrictions, and

4. time constraints.

The appraisal industry is currently undergoing major changes as uniform standards and state licensing are beginning to be enforced.

The next lesson begins the details of specific types of appraisals, beginning with appraisals of real estate and real property. Throughout the rest of the course, we will be looking at actual and hypothetical appraisals and trying to evaluate their worth in our cases.

Lesson 6

Closely Held Corporations – Financial Analysis

Contents

Introduction

We have been learning the basics of valuation through the study of real estate and personal property. The next lessons are going to show you how the valuation of a closely held corporation is prepared.

This type of valuation is really a combination of valuation methods as different assets, whether real or personal, tangible or intangible, or investment or income-producing, are analyzed, compared and capitalized.

Before we get too deeply into the valuation of closely held corporations, we will review some of the financial ratios that are considered. To introduce you to this type of analysis, it is necessary to review this terminology and these ratios so that we know for sure that we are all speaking the same language. That is the purpose of this lesson.

In the next lesson, we will discuss Rev. Rul. 59-60 which is the basis of all closely held business valuations, as well as other rulings that have built on that ruling. Once his groundwork is established, we will use a case study to show the application of these ratios and revenue rulings.

In subsequent lessons, we will be adding additional factors that must be considered. We will also be discussing how discounts are applied to make the valuations realistic.

The analysis of financial statement ratios tell a great deal about the strengths and weaknesses of a company. Generally, financial analysis includes a comparison of certain key ratios with either a standard for the industry or certain selected comparable companies. This lesson provides definitions for some of the commonly used financial ratios. Many of the concepts will merely be review for you.

Objective

At the end of this lesson, you will be able to compute the primary financial statement ratios.

Balance Sheet Ratios

Although there are many ratios used in financial analysis, we will only be looking at a select group of ratios.

The following financial statements will be used for example purposes:

Figure 6-1

Marion Company December 31, 1995 Balance Sheet			
Assets		**Liabilities**	
Current Assets (C/A)		**Current Liabilities (C/L)**	
Cash	$ 25,245	Accounts Payable	$128,646
Accounts Receivable	116,176	Notes Payable	155,082
Inventory	<u>121,014</u>	Current LTD	<u>119,428</u>
Total C/A	$262,435	Total C/L	$403,156
Fixed Assets		**Long Term Liabilities**	
Land	$ 436,449	LTD	$2,283,089
Plant & Equipment	3,831,949	Total Liabilities	2,686,245

Less: Accumulated Depreciation	(1,233,283)	**Equity**	
Other Fixed Assets	637,159		
Total Fixed Assets	3,672,274	Stock & Capital Retained Earnings	811,780 436,684
		Total Equity	1,248,464
Total Assets	$3,934,709	Total Liabilities & Equity	$3,934,709

Current Ratio

The current ratio is a test of whether the company has sufficient liquidity to pay its current liabilities. Current assets divided by current liabilities equals the current ratio. For Marion Company, this ratio is:

Current Ratio
$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$262,435}{\$403,156} = 0.65$

Quick Ratio

The quick ratio is a more stringent test for liquidity. The total of cash, cash equivalents (marketable securities, for example) and accounts receivable, divided by current liabilities equals to the quick ratio. In the case of the Marion Company, this ratio comes from the following information:

Current Assets and Liabilities			
Cash	$ 25,245	Accounts Payable	$128,646
Accounts Receivable	116,176	Notes Payable	155,082
		Current LTD	119,428
Total C/A	$141,421	Total C/L	$403,156

As you can see, in this case the quick ratio is:

Quick Ratio

Quick Current Assets / Total Current Liabilities	=	$141,421 / $403,156	=	0.35

Debt to Assets Ratio

The extent of leverage or financial risk may be measured by this ratio. Total liabilities (current and long-term) divided by total assets equals the debt to assets ratio. For Marion Company, this ratio is:

Debt to Assets Ratio				
Total Liabilities / Total Assets	=	$2,686,245 / $3,934,709	=	0.68

Equity to Total Assets Ratio

The equity to total assets ratio is simply the total shareholders' equity divided by total assets. Therefore, this figure is the inverse of the above debt to assets ratio. (i.e., 1 minus the debt to assets ratio equals the equity to total assets ratio). In the case of Marion Company, this is [1-.68] = .32, or calculated directly:

Equity to Total Assets Ratio				
Stock & Capital + Retained Earnings (Total Equity) / Total Assets	=	$811,780 + 436,684 (1,248,464) / 3,934,709	=	0.32

Fixed Assets to Equity Ratio

This ratio is a measure of how much of the company's fixed assets are financed by equity. Net fixed assets divided by total equity equals the fixed assets to equity ratio.

Fixed Assets		**Equity**	
Land	436,449	Common Stock	811,780
Plant & Equip	3,831,949	Retained Earnings	436,684
Less Accumulated Depreciation	(1,233,283)		
Other Fixed Assets	637,159		
Total Fixed Assets	3,672,274	Total Equity	1,248,464

Using this information, the fixed assets to equity ratio for Marion Company is:

Fixed Assets to Equity Ratio
$\frac{\text{Fixed Assets}}{\text{Equity}} = \frac{\$3,672,274}{\$1,248,464} = 2:94$

Note: Read, in the Pratt text, Chapter 8, "Comparative Ratio Analysis" from the beginning to "Activity Ratios," pages 129 through 131, and "Balance Sheet Leverage Ratios," pages 137 to 139.

Profit and Loss (P&L) Ratios

For the Marion Company, the following is the income statement for the year ending December 31, 1995:

Figure 6-2

Marion Company December 31, 1995 Income Statement		
Total Sales		**$1,199,468**
Operating Expenses		
Depreciation	119,264	
Other	717,357	
Total		(836,621)
Operating Income		362,847
Other Income		8,857
Interest Expense		(142,198)
Income Tax		(95,941)
Net Income		133,565

$$\text{Earnings/Share} = \frac{133,565 \text{ Income}}{53,391 \text{ Shares}} = \$2.50/\text{Share}$$

Percentage of Income Statement - Ratio Analysis

An analysis of the income statement where sales is the baseline 100 percent and other activity is computed as a percent of sales reveals many ratios which are useful when evaluating a company's financial performance.

Marion Company **December 31, 1995** **Income Statement** **Ratio Analysis**		
Total Sales*	$1,199,468	100.0%
Operating Expenses		
Depreciation	119,264	9.9%
Other	717,357	59.8%
Total	($836,621)	69.7%
Operating Income	362,847	30.3%
Other Income	8,857	.7%
Interest Expense	(142,198)	11.9%
Income Tax	(95,941)	7.9%
Net Income	$133,565	11.1%

$$\text{Earnings/Share} = \frac{\$133{,}565 \text{ Income}}{53{,}391 \text{ Shares}} = \$2.50/\text{Share}$$

* Because this example is based on a utility company, there is no cost of goods sold.

Payout Ratio

This is a measure of the portion of net income that is paid out as dividends. The payout ratio equals dividends divided by net income. For our example, if dividends of $78,040 were declared and paid from net income of $133,565, it would indicate the payout ratio would be computed as follows:

Payout Ratio

$$\frac{\text{Dividends}}{\text{Net Income}} = \frac{78{,}040}{133{,}565} = .58:1 \text{ or } 58\%$$

Hybrid Ratios

Note: Read Chapter 8, "Income Statement Profitability Ratios," pages 140 through 144 of the Pratt Text.

The hybrid ratios, in general, are based on the income statement of a company and the statement of changes in financial position, as well as the balance sheet.

The statement of change is as follows:

Figure 6-3

Marion Company Statement of Change 1/1/95 to 12/31/95		
	1/1/95	**12/31/95**
Total Assets	$3,919,306	$3,934,709
Long Term Debt	2,354,123	2,283,089
Stock & Capital	887,075	811,780
Retained Earnings	381,159	436,684
Total LTD + Equity	$3,622,357	$3,531,553

Return on Equity Ratio

In essence, this ratio relates income to total equity. The current year's net income (net of tax) is divided by year-end stockholders equity.

Return On Equity Ratio
$\frac{\text{Net Income}}{\text{Year-End Total Equity}}$ -or- $\frac{133{,}565}{1{,}248{,}464} = 10.7\%$

Return on Total Assets Ratio

This ratio is the same as the above return on equity ratio except that it uses total assets in the denominator. In other words, it is a measure of the return on total assets. The formula is net income divided by year-end total assets.

Return on Total Assets Ratio
$\frac{\text{Net Income}}{\text{Year-End Total Assets}}$ -or- 133,565 = 3.4%

3,934,709

Valuation Ratios

Yield Formula

Valuation ratios are market-based ratios and, as such, can only be calculated for publicly traded companies whose stocks are traded in the marketplace and not private companies.

"Yield" represents the dividend percentage paid on the current value of stock. The formula is annual dividends per share divided by the current stock price. Again, in our example, a 4.8 percent yield on a share of stock is computed as:

Yield Formula						
Total Dividends / Total Shares	=	78,040 / 53,391	=	$1.46/Share	=	4.8%
Current Stock Price		$30.50		$30.50 share		

Note: These ratios can only be calculated for publicly traded companies and not private companies.

Price/Earnings (P/E) Ratio

The Price/Earnings ratio is simply the current price of the company's stock divided by its annual earnings.

Price/Earnings (P/E) Ratio				
Current Price / Annual Earnings	=	$30.50/Share / $ 2.50/Share	=	12.2

It follows that the P/E ratio times annual earnings equals the price of the stock. Note that 12.2 times $2.50 of earnings indicates a price per share of $30.50.

Price/Book Value (P/BV) Ratio

The Price/Book Value Ratio is the same as the P/E ratio except that the denominator is book value rather than earnings. Therefore the P/BV ratio provides a multiple of book value to arrive at the current price.

Price/Book Value (P/BV) Ratio				
Current Price / Book Value	=	$30.50/Share / $23.38/Share*	=	1.30
Assets - Liabilities / Total Shares	=	1,248,464 / 53,391	=	23.38/Share

* In other words, the current stock price is 130 percent of the book value of shareholders equity allocable to one common share.

Summary

In this lesson, you have reviewed some of the common ratios used in financial and valuation analysis of businesses. Regardless of how much you know about financial and valuation analysis and ratios, a problem arises when there are no financial statements to work from. This is often the case with small closely held businesses. Sometimes it is difficult to determine the accounting methods used, much less the changes in the amounts over time. That is when published industry statistics and ratios come in handy.

In the next lesson, we will be providing you with numerous sources of information that you can use to analyze the case before you. You will also be learning what factors are considered in valuing a closely held business. We will then apply some of these ratios to a hypothetical situation.

Lesson 7

Introduction to Valuation of Closely Held Business Interests

Contents

Introduction

There are approximately 2,500,000 corporations in the U. S. Thirty thousand of them are traded over-the-counter (OTC) or on one of the regional or national stock exchanges. In fact, only 10,000 of these publicly traded corporations are considered to be "actively traded." Because the majority of American corporations are owned privately, closely held stock valuation issues arise frequently.

Some of what you will b e reading will be review but some information will be new as well. After reading and discussing this lesson, you will participate in a case study exercise. You will be provided with opportunities to apply the principles of financial analysis and the accepted valuation methods and approaches which you are required to know when you are acting in the dual role of investment securities analyst and appeals officer.

Objectives

At the end of this lesson, you will be able to:

1. List and apply the most significant factors to be considered in the valuation of closely held securities.

2. State the major characteristics of the five different types of business interests and differentiate among their valuation techniques.

Valuation of Closely Held Corporations

A corporation is an entity created by state law. Ownership is evidenced by shares of stock. Recall that the characteristics of a corporation are:

1. There is limited shareholder liability,

2. The corporation, generally, has an unlimited life,

3. The rights of the shareholders are determined by state law, the articles of incorporation and the corporate bylaws,

4. The corporation has centralized management, and

5. The corporation has free transferability of ownership interest.

A “closely held” corporation is one where ownership is not widely dispersed. It has the characteristics of a regular corporation but typically also has others not found in publicly traded stocks:

1. Lack of marketability of the corporation’s stock,

2. Concentration of management and voting in a small group,

3. Influence of shareholders’ personal circumstances on dividend policy, and

4. Lack of access to public markets for capital funds.

Once the characteristics of a closely held corporation are determined, it is interesting to see what effect these characteristics have on a valuation of the stock of the corporation.

Fair Market Value — Standard for Valuation

The objective in valuing any business entity is to determine its fair market value. Fair market value is defined as the price at which the business “would change hands between a willing buyer and willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of relevant facts.” Note that the definition is the same as that for real estate and art works. No matter what the object of the valuation, these factors must be present. Treas. Reg. § 20.2031.1(b).

Treas. Reg. §§ 20.2031-2 and 25.2512-2 relate to the valuation of stocks and bonds, and the first principle is that the value should be based on the selling price of such securities on a stock exchange, in an over-the-counter market or other market.

If selling prices are not available, the regulations provide that the fair market value of stock in a corporation is to be determined by taking into consideration the company’s net worth, prospective earning power and dividend paying capacity and “other relevant factors.”

Revenue Ruling 59-60 and Related Rulings

The beginning point for any business valuation is Rev. Rul. 59-60,[xiv] which is the Service’s general guideline in valuing closely held stock. This ruling has been modified by Rev. Rul. 65-193[xv] and further amplified by Rev. Ruls. 77-287 and 83-120.[xvi] See **Exhibits 7-1** through **7-4.**

Factors to Consider

Section 4.01 and Rev. Rul. 59-60 lists certain factors which, though not all inclusive, are fundamental and require careful analysis in each case.

Section 5 of the ruling deals with the comparative weight to be accorded these factors. It states that primary consideration should be given to earnings when valuing stocks of companies selling products or services to the public, whereas the greatest weight should be given to asset value when valuing stocks of investment holding companies.

Section 6 focuses on capitalization of earnings and dividends and notes that determining the appropriate capitalization rate which "presents one of the most difficult problems in valuation."

Section 7 warns against averaging the results of several valuation approaches.

Section 8 discusses the effect of restrictive agreements on valuation.

We will be discussing each of these sections in more detail in the following sections.

Type of Business

When approaching a valuation issue you must consider the nature and the history of the company to be valued. The nature is important because the industry within which the company operates will influence the weight accorded the various approaches to valuation and will furnish the comparable companies against which the company's value is measured. For example, the average price/earnings ratios of chemical companies may be 6 while biotech companies may be averaging 30. The difference reflects a dissimilarity in both risk and expectation between the industries. Any valuation which did not take this industry difference into account would be of little value.

The history of the particular enterprise is also important. An analysis of the company's corporate minute book, for example, might reveal the existence of new product lines or increased competition, both factors which could make past operating experience invalid indicators of future earnings. The stock ledger, on the other hand, might reveal actual trades of stock or other family relationships which may be affecting the market for the stock. It is easy to see why an analysis of nature and history is the starting point of any valuation.

Economic Outlook

The informed "stock analyst" must always view the value of a stock in the context of how the financial markets view the overall economy. (If the business is a regional business, the regional economy should be analyzed also.) Inevitably, their view will affect both the price/earnings ratio and asset values. In addition, past fluctuations in the company's costs and earnings can frequently be explained by reference to the national economy.

Net Asset Valuation — Book Value

Book value is merely the historical or accounting value of the corporation's assets over its liabilities. Normally, in the case of a minority interest, book value should be a subordinate factor in determining market value. See Tully Estate v. Commissioner and Central Trust v. United States.[xvii]

Special situations, however, can have a dramatic effect in enhancing book value as a fair market value indicator. Such might be the case where a liquidation is in process or is imminent. See Forbes v. Hasset.[xviii] Another common example is a failing company with an asset value well in excess of any earnings-derived value. See Hayes Estate v. Commissioner.[xix] Rev. Rul. 59-60, section 5(a) specifies use of book value where a holding company is involved. Certain special industries, such as auto dealerships and real estate development companies, are almost always valued using a multiple of book value. See Rothgery v. United States and Huntington Estate v. Commissioner.[xx]

Where book value is used in one of the above situations, adjustments to historical book value are routinely required. Typical adjustments might include increasing fixed assets to fair market value, adjusting inventory for a last-in-first-out (LIFO) reserves or correcting excess depreciation on assets. The resulting figure is “adjusted book value” or “net asset value.”

Earnings Value/Comparable Companies

The earning power of a company is the most important criterion on value when valuing a company engaged in selling products or services to the public. While it is future returns which is of primary interest to the investor, typically the best evidence of future earnings is past earnings history. In determining future earning power by reference to past earnings, several points need to be examined:

1. **Number of past years taken into account —** Rev. Rul. 59-60 states that generally, five or more years of prior earnings should be taken into account. If the corporation has not been in business for five years or its business has substantially changed, a shorter period may be necessary.

2. **Earnings trends —** A marked trend in earnings, either upward or downward, is very important. If earnings are trending upward over a five-year period, for example, it may be proper to assign mathematically greater weight to the most recent year’s earnings using a “weighted average” approach. If there is no definite trend in earnings, the business may be “cyclical” and a single average of the five years’ earnings may be the best indicator.

3. **Price/earnings ratio —** Once the future earnings power of a company has been computed, the next step is to find the appropriate multiple which an investor will pay for those earnings. This earnings multiplier is called “P/E ratio.”

   The first step in determining a P/E ratio is to select from available sources (see **Exhibit 7-5**), the publicly traded companies which are most comparable to the closely held company to be valued. Once comparables have been found, an appropriate price/earnings multiplier, selected by comparison to the P/E ratios of those companies, as of the valuation date, can then be applied to the earnings of the company being valued to produce a valuation.

4. **Adjustment for nonoperating assets and nonrecurring events —** Before a comparison of earnings with publicly traded companies is undertaken, it is necessary to adjust the subject company’s earnings by removing nonrecurring factors, such as unusual capital gains. In

addition, income from substantial nonoperating assets should be separated from the operating net income.

Dividend Paying Capacity

In the case of closely held or family-owned corporations, which usually do not pay dividends, the actual dividend yield may constitute a gross understatement of the ability of the company to pay dividends. Recognition of this fact has resulted in emphasis being placed on **dividend paying capacity** (as opposed to the actual dividend record because no dividends may be paid because of the chance of the company's controlling stockholders) in Rev. Rul. 59-60. This may necessitate looking at the company's current need for surplus corporate funds, such as for plant expansion or new product research.

Goodwill

For purposes of valuation, goodwill can be defined as the excess of earnings over and above a fair rate of return on net tangible assets. Another definition is the extent that the appraised value of net tangible assets exceeds net book value.

Demonstrated earning power is the primary evidence of goodwill. See McKee v. Commissioner.[xxi] On the other hand, goodwill or other intangible value may be present in an enterprise, even though a series of loss years precedes the valuation date.

Sales of the Stock of the Subject Company

The above discussion has dealt with "intrinsic factors" relating to the financial condition of the subject company, such as earnings capacity, book value, dividend paying capacity and intangible value. Analysis of such factors is necessary only when there is no valid restrictive agreement controlling valuation and when insufficient sales of the subject stock exist. The general rule is that market prices are the best indicators of value. Judge Learned Hand, in the Commissioner v. McCann has stated the rationale as follows:

> **Extract**
>
> Commissioner v. McCann, 5 T.C.M. 92 (on remand), (2nd Cir.), 45-1 U.S.T.C. 10,160, 146 F.2d 385, 2 T.C. 702 (1943)
>
> * * * * *
>
> When there is an open market in which property can be bought and sold, it may be very difficult, if not impossible, to avoid the conclusion that the market price is the "value" for all purposes. That price is the sum which will secure the property, if anyone has parted with it; that price is the sum which represents the current estimate of the present value of its future earnings and of its final liquidation.
>
> * * * * *

Often there is some degree of market activity in a stock, even where control is held by a family group. The problem then becomes what weight to give these sales, in determining the fair market value of the subject shares. Some of the factors which must be considered include the following:

1. **Degree of market activity —** In Hunt Estate v. Commissioner,[xxii] controlling weight was given to sales of much smaller lots than those being valued. However, in Vandenhoeck Estate v. Commissioner[xxiii], the Tax Court completely ignored sales prices in smaller lots. The usual case will be somewhere in between these extremes and the existence of such sales should not be dismissed, since it provides evidence upon which a Court may base its conclusions.

2. **Proximity of sales to valuation date —** The closer the sales are to the valuation date, the greater the weight they should be expected to receive. Any material change in the financial condition of the subject company during the interim period may dramatically affect the weight of the comparable.

3. **Arms-length sales —** Sales between family members and sales between corporate insiders are not generally a reliable indicator of value. In the case of the family members, gift and estate tax considerations often play a part in the transfers. In the insider case, the corporation and the employer-employee relationship can distort the sales price. Nevertheless, the sale should be carefully reviewed, since they may be relied upon if abnormal influences are not present.

Other Business Entities

Many of the same principles of valuation which apply to closely held corporations should also be used in analyzing other entities. Therefore, Rev. Rul. 59-60 should be looked to as a primary source of guidance. Balance sheets and profit and loss statements for several years will still need to be analyzed. This data will provide insight as to the adjusted net worth and income potential of the business, whatever its form. We will briefly cover the most common forms of business ownership other than closely held corporations.

Sole Proprietorship

A sole proprietorship (also known as a Schedule C business) is wholly owned by one individual. The characteristics of a sole proprietorship are:

1. The owner has unlimited liability,

2. The owner (rather than the entity) pays income tax,

3. The sole proprietorship has a limited life, and

4. Assets of the sole proprietorship are held in the owner's name.

Since sole proprietorships depend very heavily on the activity of one individual, it is often the case that little or no goodwill, as such, will survive the proprietor's death. See Adams Estate v. Henslee.[xxiv] If an earnings approach to valuation has been used, a key man discount may be applicable to reflect this loss of goodwill. We will cover this type of discounting factor in a later lesson.

General Partnership

A general partnership is an entity created by agreement (oral or written) between two or more parties to combine assets, labor and/or skills in a business, and to share in the profits and losses of the combined business. Profits and losses do not have to be shared equally.

The characteristics of a general partnership are:

1. The partners have unlimited personal, joint and several liability,

2. The partners pay income tax on earnings of the partnership,

3. The partnership has a limited life (absent agreement to the contrary),

4. The partners have a right to bind the partnership and/or the partners by their individual acts (absent agreement to the contrary), and

5. Each partner's equity is reflected in his or her partnership capital account.

In valuing partnership or other interests that have been reduced to writing, it is necessary to review both the partnership agreement and the applicable state law to determine the rights of the partners. It is vital to the valuation to have a thorough grasp of the consequences of the death of a partner. For example, the valuation may be totally different depending on whether the partnership:

1. Is dissolved at a partner's death,

2. Continues with the partner's beneficiaries as new partners, or

3. Continues under a buyout agreement.

Several other adjustments must be made to the partnership before it can be compared directly with publicly traded companies. The most important of these adjustments are:

1. Since partners generally take their salaries in "draws," which have no effect on partnership income, an adjustment may be necessary to reflect reasonable salaries or management expenses.

2. Partnership earnings should be "converted" to corporate after-tax equivalents by the application of the appropriate corporate tax rate. The resulting "converted" earnings can then be analyzed in light of corporate P/E ratios.

3. In book value computations, the partner's capital account will need adjustment to reflect adjusted asset value and to reflect all loans receivable or payable in the name of the partner.

Limited Partnership

A limited partnership is an entity created by written agreement, having at least one general partner and one limited partner.

The characteristics of a limited partnership are, generally, the same as those of a general partnership; however, there are three significant differences.

1. The limited partner's liability is limited to the investment in the partnership,

2. Each limited partner's interest in the partnership is freely transferable, and

3. A limited partner may not participate in management.

Valuation of limited partnership interests presents other difficult problems. Quite often, the value of a partner's interest is limited to his or her capital contribution or the proportionate share of the net assets of the enterprise. However, certain industries, such as the oil and gas exploration industry, in which business interests are held in the form of limited partnerships, value such interests by recognized formulas.

You may want to seek the aid of industry professionals both in and outside of the Service (such as IRS engineers specializing in the oil and gas industries), to determine if standard approaches to valuation exist in your area of concern and whether or not these approaches were followed in the appraisal included in the case file.

Subchapter S Corporations

A corporation is generally taxed at a separate rate than individuals. If the shareholders of a company elect to be taxed under Subchapter S of the Code (S Corporation), the shareholders are taxed directly on their proportionate share of the company's total profits or losses.

These corporations are treated similarly to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

Valuation Approaches

Rev. Rul. 59-60 emphasizes the most common methods of valuation:

1. Adjusted book value,

2. Comparable price,

3. Excess earnings, and

4. Capitalization of earnings.

Although the ruling does not specify other methods of valuation, there are others that must be considered.

1. Discounted future earnings, and

2. Discounted cash flow.

(Below are brief illustrations of the valuation methods. The class exercise at the end of this lesson is an example of the first 5 methods.)

Adjusted Book Value

Adjusted book value, sometimes called the "net tangible asset (NTA) method," is computed by taking the book value of the business (which is historically the assets over liabilities, booked at cost) and making adjustments for:

- FMV of assets,
- Excess Depreciation,
- Other deceptive items such as LIFO reserves.

Adjusted Book Value Method
Assets - Liabilities +/- adj FMV of assets - excess depreciation +/- other (LIFO, etc.)
Adjusted book value

This method is useful for the valuation of investment companies like real estate holding companies. It is also used in the case of a company that is about to be liquidated.

Comparable Price

The comparable price method requires an assumption that the values of other companies are comparable to the closely held business being valued. In order to use this method, lit is suggested that at least three comparables be found. Finding this many comparables can cause a problem and may mean this method is not appropriate.

Once you have found comparables, the P/E ratio may be used to compute the value.

Comparable Price Method				
Net	x	P/E ratio (Industry)	=	Valuation

Once you have computed the value you must apply a discount for lack of marketability of the stock of the closely held business. This is a generally accepted practice in the real world. We will be discussing this type of discounting in a subsequent lesson.

Excess Earnings

The excess earnings method is based on the theory that the value of net tangible assets plus the capitalized value of excess earnings (the goodwill factor) equals the value of the business.

The computation starts with the same net tangible assets (NTA) computed in the adjusted book value method discussed above. This is the base number but all other adjustments are made based on earnings.

The next adjustment is to remove from earnings all unusual items. This will generally include items, such as investment income (interest, dividends, etc.), which are derived from other than operations. This amount is called the "adjusted earnings."

The amount that is considered "normal earnings" based on the industry standards is then subtracted from the adjusted earnings resulting in "excess earnings." This amount is then capitalized and results in "goodwill" which is then added to the NTA for the total value.

Excess Earnings Method			
			NTA
Earnings			
Less:			
	-	Earnings not based on operations	
		Adjusted Earnings	
	-	Normal Earnings (from industry)	+ Goodwill
			Total Value

Capitalization of Earnings

The capitalization of earnings method favors the theory that the best indicator of a company value is its ability to generate cash flow.

In this method, you generally capitalize the five-year weighted average of adjusted earnings and compare it to the adjusted book value. If this value exceeds the book value method it probably is a better indicator of value.

Discounted Future Earnings (DFE)

Two methods of valuation that have gained a large measure of popularity in recent times are the discounted future earnings (DFE) method and the discounted cash flow (DCF) method. In both of these methods, instead of using past earnings data to measure future prospects, an attempt is made to actually forecast future prospects from the valuation date forward.

Although there are similarities, the DCF and DFE methods are different since the DCF requires that estimated future earnings projections be converted to estimated cash flows before applying formulas. In other words, DCF focuses on cash, rather than accounting profits.

The first step in each of these methods is to project future earnings for some period. Often, the period used is the next five years. These projections may be based on the average growth of the prior (five) years.

Once these future earnings are estimated, a discount rate must be determined. This is then applied to each of the years' estimated earnings to determine their present values. After all of the future years' earnings are discounted, the final year's earnings are capitalized and then the present value of this figure is determined. All of these values are added together to give a DFE value.

Note: Review Chapter 9 in the Pratt book for a detailed explanation of this valuation method.

Discounted Cash Flow (DCF)

With the DCF method, the net profits **after** tax are estimated for the desired future period. This profit amount is then added to the depreciation and amortization (noncash expenses). The result is cash flow before debt service and other capital requirements. After loan payments and cash needed for other purposes are removed, the present value of the remaining cash is determined using present value tables. The value of the company is the present value of the cash flow, plus the present value of any assets expected to remain in the business, less any liabilities expected to remain.

If these last two approaches sound complicated, it's because they certainly are. Potential inaccuracies have also been alleged in:

1. identifying the relevant cash flows, and

2. choosing an appropriate discount rate.

Despite the recent popularity of these approaches, you should approach these types of valuations with caution. There is a great potential for distortion because of the estimation and forecasting involved. The use of one of these methods along with a more conventional analysis may be better.

Settlement Philosophy

The following quotation reveals a judicial attitude which is probably widespread.

Extract

James T. Schwabacher, para. 46,267 PH Memo T.C. (1946), 5 T.C.M. 971

* * * * *

We have no deep-seated conviction as to what the value of the stock may have been on any of the dates, but a finding of value is necessary and has been made to the best of our ability. It would serve no useful purpose and might convince no one if we were to explain in detail just how our conclusions have been reached.

* * * * *

The Tax Court is becoming increasingly reluctant to engage in valuation of closely held stock. In Sirloin Stockade, Inc. v. Commissioner,[xxv] an income tax valuation case, Judge Tannenwald adopted the taxpayers' valuation, because he sensed that the Service was pursuing a weak case in order to secure a compromise valuation.

As discussed in Lesson 1, in Buffalo Tool and Die Mfg. Co. v. Commissioner, where the parties' positions were very close in relative merit, the Court still had enormous difficulty:

> **Extract**
>
> Buffalo Tool and Die Mfg. Co. v. Commissioner, 74 T.C. 441 (1980)
>
> * * * * *
>
> If the parties insist on our valuing any or all of the assets, we will. We do not intend to avoid our responsibilities but instead seek to administer them more efficiently — a factor which has become increasingly important in light of the constantly expanding workload of the Court.
>
> * * * * *

Later, when the parties were still unable to resolve this issue, the Court expressed its displeasure.

> **Extract**
>
> Buffalo Tool and Die Mfg. Co. v. Commissioner, 42 T.C.M. 841
>
> * * * * *
>
> We cannot refrain from making one final observation. The Court made strenuous efforts to persuade the parties to settle this case both before and after our prior opinion. A settlement was clearly the appropriate vehicle for disposition of this case in the latter period. By applying the most charitable description of the attitude of counsel for the parties, we can only assume that the talismanic quality of their respective perceptions precluded them from pursuing such a path. We wish that we were as blessed as they obviously consider themselves to be, although we cannot help but note that it took petitioner's counsel 69 pages and respondent's counsel 60 pages of supplemental briefing to articulate their perceptions. When one considers the time, effort, and expense to petitioners and respondent, to say nothing of the Court, it may not be inappropriate to ask "was it all really worth it"?
>
> * * * * *

It does not benefit either party in a valuation case to be dogmatic. An attempt should be made to obtain a "substantially correct" value based on the principles previously discussed. If this fails, the Tax Court offers an arbitration procedure which will bind both parties if they agree to implement it. Only if the taxpayer is completely unreasonable about both the merits of his valuation and his willingness to negotiate, should a case wind up before the Court for a decision.

Summary

This lesson was primarily intended to introduce you to the basic principles of valuation of closely held stock. These factors are set out in Rev. Rul. 59-60, which has been given great deference by the Courts. Though closely held corporations have been emphasized, the general principles can be slightly modified in valuing other business entities, and will be perfectly suitable. The end product is imperfect, however, since valuation is not an exact science. You should keep in mind that flexibility in this area is of utmost importance.

The next lesson contains a case study exercise demonstrating the application of these basic principles to specific facts. It should help you get a sense of the imprecise "artistry" inherent in valuing a business entity.

Class Exercise

The Franklin Company's financial condition as of year-end, 1995, is as follows:

Book Value	$ 950,000
Net Asset Value	1,750,000
Liquidation Value	1,225,000
After-Tax Income	195,000
Pre-Tax Adjusted Earnings	450,000

Additional facts:

- Franklin Company has no intangible assets.

- Comparable companies have P/E ratios of 16.5.

- Average industry rate of return on book value is 10.4% after tax and 15% pre-tax.

- Earnings are capitalized at 20%.

- Average growth over the last 5 years is 12% per year.

The value of the company on December 31, 1995 was computed using the following methods:

a. Net asset value method

From the facts given: $1,750,000

b. Comparable price method

Net Income × Industry P/E

$195,000 × 16.5 = 3,217,500

Discount for marketability (this will be discussed in a subsequent lesson) – 30%

$3,217,000 × 70%		$2,252,250

c. Excess earnings method

Net tangible asset value (NTA)		$1,750,000
Adjusted Earnings	$450,000	
Industry Earnings		
15% of NTA	262,500	
Excess Earning	$187,500	
Capitalized at 20% (goodwill)		937,500
Excess earnings value		$2,687,500

d. Capitalization of earnings method

Adjusted earnings	$450,000
Capitalization rate	+.20
Capitalization of earning value	$2,250,000

e. Discounted future earnings method

Year	Projected Earnings	Discounted P/V*
1996	$504,000	$420,000
1997	564,000	391,667
1998	620,000	358,796
1999	675,000	325,521
2000	722,000	290,156
Subtotal		1,786,140

Fifth year 2000 @ 20% capitalization

$\frac{\$722,000}{.20}$ = 3,610,000 1,450,778

Discounted future earnings value $3,236,918

*Projected earnings discounted back to present value at a discount rate of 20%.

What range would you establish for settlement? Why?

Is there another method that would be more appropriate? What other facts do you need?

26 CFR 20.2031-2: Valuation of stocks and bonds
(Also Section 2512.)
(Also Part II, Sections 811 (k), Regulations 105, Section 81.10.)

Rev. Rul. 59-60

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.

Revenue Ruling 54-77, C.B. 1954-1, 187, superseded.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

SEC. 2. BACKGROUND AND DEFINITIONS.

.01 All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031 (a), 2032 and 2512(a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

02. Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be

well informed about the property and concerning the market for such property.

03. Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

SEC. 3. APPROACH TO VALUATION.

.01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgement and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02 The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03 Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

SEC. 4. FACTORS TO CONSIDER.

.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

.02 The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm’s length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation’s stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(h) Section 2031 (b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used.

The essential factor is that whether the stocks are sold on an exchange or over-the counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

SEC. 5. WEIGHT TO BE ACCORDED VARIOUS FACTORS.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

SEC. 6. CAPITALIZATION RATES.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

SEC. 7. AVERAGE OF FACTORS.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

SEC. 8. RESTRICTIVE AGREEMENTS.

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bonafide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2, 255, and Rev. Rul. 189, C.B. 1953-2, 294.

SEC. 9. EFFECT ON OTHER DOCUMENTS.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.

Exhibit 7-2

26 CFR 20.2031-2: Valuation of stocks and bonds.
(Also Sections 1001, 2512; 1.1001-1,25.2512-2.)

Rev. Rul. 65-193

Revenue Ruling 59-60, C.B. 1959-1, 237, is hereby modified to delete the statements, contained therein at section 4.02(f), that “In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.”

The instances where it is not possible to make a separate appraisal of the tangible and intangible assets of a business are rare and each case varies from the other. No rule can be devised which will be generally applicable to such cases.

Other than this modification, Revenue Ruling 59-60 continues in full force and effect. See Rev. Rul. 65-192, page 259, this Bulletin.

Section 1. Purpose.

.01 The purpose of this Revenue Ruling is to amplify Rev. Rul. 59-60, 1959-1 C.B. 237, as modified by Rev. Rul. 65-193, 1965-2 C.B. 370, and to provide information and guidance to taxpayers, Internal Revenue Service personnel, and others concerned with the valuation, for Federal tax purposes, of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities laws. This guidance is applicable only in cases where it is not inconsistent with valuation requirements of the Internal Revenue Code of 1954 or the regulations thereunder. Further, this ruling does not establish the time at which property shall be valued.

Section 2. Nature of the Problem.

It frequently becomes necessary to establish the fair market value of stock that has not been registered for public trading when the issuing company has stock of the same class that is actively traded in one or more securities markets. The problem is to determine the difference in fair market value between the registered shares that are actively traded and the unregistered shares. This problem is often encountered in estate and gift tax cases. However, it is sometimes encountered when unregistered shares are issued in exchange for assets or the stock of an acquired company.

Section 3. Background and Definitions.

.01 The Service outlined and reviewed in general the approach, methods, and factors to be considered in valuing shares of closely held corporate stock for estate and gift tax purposes in Rev. Rul. 59-60, as modified by Rev. Rul. 65-193. The provisions of Rev. Rul. 59-60, as modified, were extended to the valuation of corporate securities for income and other tax purposes by Rev. Rul. 68-609, 1968-2 C.B. 327.

.02 There are several terms currently in use in the securities industry that denote restrictions imposed on the resale and transfer of certain securities. The term frequently used to describe these securities is “restricted securities” but they are sometimes referred to as “unregistered securities,” “investment letter stock,” “control stock," or "private placement stock." Frequently these terms are used interchangeably. They all indicate that these particular securities cannot lawfully be distributed to the general public until a registration statement relating to the corporation underlying the securities has been filed, and has also become effective under the rules promulgated and enforced by the United States Securities & Exchange Commission (SEC) pursuant to the Federal securities laws. The following represents a more refined definition of each of the following terms along with two other terms—"exempted securities" and "exempted transactions."

(a) The term "restricted securities" is defined in Rule 144 adopted by the SEC as "securities acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering."

(b) The term "unregistered securities" refers to those securities with respect to which a registration statement, providing full disclosure by the issuing corporation, has not been filed with the SEC pursuant to the Securities Act of 1933. The registration statement is a condition precedent to a public distribution of securities in interstate commerce and is aimed at providing the prospective investor with a factual basis for sound judgment in making investment decisions.

(c) The terms "investment letter stock" and "letter stock" denote shares of stock that have been issued by a corporation without the benefit of filing a registration statement with the SEC. Such stock is subject to resale and transfer restrictions set forth in a letter agreement requested by the issuer and signed by the buyer of the stock when the stock is delivered. Such stock may be found in the hands of either individual investors or institutional investors.

(d) The term "control stock" indicates that the shares of stock have been held or are being held by an officer, director, or other person close to the management of the corporation. These persons are subject to certain requirements pursuant to SEC rules upon resale of shares they own in such corporations.

(e) The term “private placement stock” indicates that the stock has been placed with an institution or other investor who will presumably hold it for a long period and ultimately arrange to have the stock registered if it is to be offered to the general public. Such stock may or may not be subject to a letter agreement. Private placements of stock are exempted from the registration and prospectus provisions of the Securities Act of 1933.

(f) The term “exempted securities” refers to those classes of securities that are expressly excluded from the registration provisions of the Securities Act of 1933 and the distribution provisions of the Securities Exchange Act of 1934.

(g) The term “exempted transactions” refers to certain sales or distributions of securities that do not involve a public offering and are excluded from the registration and prospectus provisions of the Securities Act of 1933 and distribution provisions of the Securities Exchange Act of 1934. The exempted status makes it unnecessary for issuers of securities to go through the registration process.

SECTION 4. SECURITIES INDUSTRY PRACTICE IN VALUING RESTRICTED SECURITIES.

.01 *Investment Company Valuation Practices*. The Investment Company Act of 1940 requires open-end investment companies to publish the valuation of their portfolio securities daily. Some of these companies have portfolios containing restricted securities, but also have unrestricted securities of the same class traded on a securities exchange. In recent years the number of restricted securities in such portfolios has increased. The following methods have been used by investment companies in the valuation of such restricted securities:

(a) Current market price of the unrestricted stock less a constant percentage discount based on purchase discount;

(b) Current market price of unrestricted stock less a constant percentage discount different from purchase discount;

(c) Current market price of the unrestricted stock less a discount amortized over a fixed period;

(d) Current market price of the unrestricted stock; and

(e) Cost of the restricted stock until it is registered.

The SEC ruled in its Investment Company Act Release No. 5847, dated October 21, 1969, that there can be no automatic formula by which an investment company can value the restricted securities in its portfolios. Rather, the SEC has determined that it is the responsibility of the board of directors of the particular investment company to determine the "fair value" of each issue of restricted securities in good faith.

.02 *Institutional Investors Study*. Pursuant to Congressional direction, the SEC undertook an analysis of the purchases, sales, and holding of securities by financial institutions, in order to determine the effect of institutional activity upon the securities market. The study report was published in eight volumes in March 1971. The fifth volume provides an analysis of restricted securities and deals with such items as the characteristics of the restricted securities purchasers and issuers, the size of transactions (dollars and shares), the marketability discounts on different trading markets, and the resale provisions. This research project provides some guidance for measuring the discount in that it contains information, based on the actual experience of the marketplace, shown that, during the period surveyed (January 1, 1966, through June 30, 1969), the amount of discount allowed for restricted securities from the trading price of the unrestricted securities was generally related to the following four factors.

(a) *Earnings*. Earnings and sales consistently have a significant influence on the size of restricted securities discounts according to the study. Earnings played the major part in establishing the ultimate discounts at which these stocks were sold from the current market price. Apparently earnings patterns, rather than sales patterns, determine the degree of risk of an investment.

(b) *Sales*. The dollar amount of sales of issuers' securities also has a major influence on the amount of discount at which restricted securities sell from the current market price. The results of the study generally indicate that the companies with the lowest dollar amount of sales during the test period accounted for most of the transactions involving the highest discount rates, while they accounted for only a small portion of all transactions involving the lowest discount rates.

(c) *Trading Market*. The market in which publicly held securities are traded also reflects variances in the amount of discount that is applied to restricted securities purchases. According to the study, discount rates were greatest on restricted stocks with unrestricted counterparts traded over-the-counter, followed by those with unrestricted counterparts listed on the American Stock Exchange, while the discount rates for those stocks with unrestricted counterparts listed on the New York Stock Exchange were the smallest.

(d) *Resale Agreement Provisions*. Resale agreement provisions often affect the size of the discount. The discount from the market price provides the main incentive for a potential buyer to acquire restricted securities. In judging the opportunity cost of freezing funds, the purchaser is analyzing two separate factors. The first factor is the risk that underlying value of the stock will change in a way that, absent the restrictive provisions, would have prompted a decision to sell. The second factor is the risk that the contemplated means of legally disposing of the stock may not materialize. From the seller's point of view, a discount is justified where the seller is relieved of the expenses of registration and the public distribution, as well as of the risk that the market will adversely change before the offering is completed. The ultimate agreement between buyer and seller is a reflection of these and other considerations. Relative bargaining strengths of the parties to the agreement are major considerations that influence the resale terms and consequently the size of discounts in restricted securities transactions. Certain provisions are often found in agreements between buyers and sellers that affect the size of discounts at which restricted stocks are sold. Several such provisions follow, all of which, other than number (3), would tend to reduce the size of the discount:

(1) A provision giving the buyer an option to "piggyback", that is, to register restricted stock

with the next registration statement, if any, filed by the issuer with the SEC;

(2) A provision giving the buyer an option to require registration at the seller's expense;

(3) A provision giving the buyer an option to require registration, but only at the buyer's own expense;

(4) A provision giving the buyer a right to receive continuous disclosure of information about the issuer from the seller;

(5) A provision giving the buyer a right to select one or more directors of the issuer;

(6) A provision giving the buyer an option to purchase additional shares of the issuer's stock; and

(7) A provision giving the buyer the right to have a greater voice in operations of the issuer, if the issuer does not meet previously agreed upon operating standards.

Institutional buyers can and often do obtain many of these rights and options from the sellers of restricted securities, and naturally, the more rights the buyer can acquire, the lower the buyer's risk is going to be, thereby reducing the buyer's discount as well. Smaller buyers may not be able to negotiate the large discounts or the rights and options that volume buyers are able to negotiate.

.03 *Summary*. A variety of methods have been used by the securities industry to value restricted securities. The SEC rejects all automatic or mechanical solutions to the valuation of restricted securities, and prefers, in the case of the valuation of investment company portfolio stocks, to rely upon good faith valuations by the board of directors of each company. The study made by the SEC found that restricted securities *generally* are issued at a discount from the market value of freely tradable securities.

SECTION 5. FACTS AND CIRCUMSTANCES MATERIAL TO VALUATION OF RESTRICTED SECURITIES.

.01 Frequently, a company has a class of stock that cannot be traded publicly. The reason such stock cannot be traded may arise from the securities statutes, as in the case of an "investment letter" restriction; it may arise from a corporate charter restriction, or perhaps from a trust agreement restriction. In such cases, certain documents and facts should be obtained for analysis.

.02 The following documents and facts, when used in conjunction with those discussed in Section 4 of Rev. Rul. 59-60, will be useful in the valuation of restricted securities:

(a) A copy of any declaration of trust, trust agreement, and any other agreements relating to the shares of restricted stock;

(b) A copy of any document showing any offers to buy or sell or indications of interest in buying or selling the restricted shares;

(c) The latest prospectus of the company;

(d) Annual reports of the company for 3 to 5 years preceding the valuation date;

(e) The trading prices and trading volume of the related class of traded securities 1 month preceding the valuation date, if they are traded on a stock exchange (if traded over-the-counter, prices may be obtained from the National Quotations Bureau, the National Association of Securities Dealers Automated Quotations (NASDAQ), or sometimes from broker-dealers making markets in the shares);

(f) The relationship of the parties to the agreements concerning the restricted stock, such as whether they are members of the immediate family or perhaps whether they are officers or directors of the company; and

(g) Whether the interest being valued represents a majority or minority ownership.

SECTION 6. WEIGHING FACTS AND CIRCUMSTANCES MATERIAL TO RESTRICTED STOCK VALUATION.

All relevant facts and circumstances that bear upon the worth of restricted stock, including those set forth above in the preceding Sections 4 and 5, and those set forth in Section 4 of Rev. Rul. 59-60, must be taken into account in arriving at the fair market value of such securities. Depending on the circumstances of each case, certain factors may carry more weight than others. To illustrate:

.01 Earnings, net assets, and net sales must be given primary consideration in arriving at an appropriate discount for restricted securities from the freely traded shares. These are the elements of value that are always used by investors in making investment decisions. In some cases, one element may be more important than in other cases. In the case of manufacturing, producing, or distributing companies, primary weight must be accorded earnings and net sales; but in the case of investment or holding companies, primary weight must be given to the net assets of the company underlying the stock. In the former type of companies, value is more closely linked to past, present, and future earnings while in the latter type of companies, value is more closely linked to the existing net assets of the company. See the discussion in Section 5 of Rev. Rul. 59-60.

.02 Resale provisions found in the restriction agreements must be scrutinized and weighed to determine the amount of discount to apply to the preliminary fair market value of the company. The two elements of time and expense bear upon this discount; the longer the buyer of the shares must wait to liquidate the shares, the greater the discount. Moreover, if the provisions make it necessary for the buyer to bear the expense of registration, the greater the discount. However, if the provisions of the restricted stock agreement make it possible for the buyer to "piggyback" shares at the next offering, the discount would be smaller.

.03 The relative negotiation strengths of the buyer and seller of restricted stock may have a profound effect on the amount of discount. For example, a tight money situation may cause the buyer to have the greater balance of negotiation strength in a transaction. However, in some cases the relative strengths may tend to cancel each other out.

.04 The market experience of freely tradable securities of the same class as the restricted securities is also significant in determining the amount of discount. Whether the shares are privately held or publicly traded affects the worth of the shares to the holder. Securities traded on a public market generally are worth more to investors than those that are not traded on a public market. Moreover, the type of public market in which the unrestricted securities are traded is to be given consideration.

SECTION 7. EFFECT ON OTHER DOCUMENTS.

Rev. Rul. 59-60, as modified by Rev. Rul. 65-193, is amplified.

SECTION 2512.—VALUATION OF GIFTS

26 CFR 25.2512-2: Stocks and bonds.
(Also Sections 305, 351, 354, 368, 2031; 1.305-5, 1.351-1, 1.354-1, 1.368-1, 20.2031-2.)

Valuation; stock; closely held business. The significant factors in deriving the fair market value of preferred and common stock received in certain corporate reorganizations are discussed. Rev. Rul. 59-60 amplified.

Rev. Rul. 83-120

SECTION 1. PURPOSE

The purpose of this Revenue Ruling is to amplify Rev. Rul. 59-60, 1959-1 C.B. 237, by specifying additional factors to be considered in valuing common and preferred stock of a closely held corporation for gift tax and other purposes in a recapitalization of closely held businesses. This type of valuation problem frequently arises with respect to estate planning transactions wherein an individual receives preferred stock with a stated par value equal to all or a large portion of the fair market value of the individual's former stock interest in a corporation. The individual also receives common stock which is then transferred, usually as a gift, to a relative.

SECTION 2. BACKGROUND

.01 One of the frequent objectives of the type of transaction mentioned above is the transfer of the potential appreciation of an individual's stock interest in a corporation to relatives at a nominal or small gift tax cost. Achievement of this objective requires preferred stock having a fair market value equal to a large part of the fair market value of the individual's former stock interest and common stock having a nominal or small fair market value. The approach and factors described in this Revenue Ruling are directed toward ascertaining the true fair market value of the common and preferred stock and will usually result in the determination of a substantial fair market value for the preferred stock which is substantially less than its par value.

.02 The type of transaction referred to above can arise in many different contexts. Some examples are:

(a) *A* owns 100% of the common stock (the only outstanding stock) of *Z* Corporation which has a fair market value of 10,500x. In a recapitalization described in section 368(a)(1)(E), *A* receives preferred stock with a par value of 10,000x and new common stock, which *A* then transfers to *A*'s son *B*.

(b) *A* owns some of the common stock of *Z* Corporation (or the stock of several corporations) the fair market value of which stock is 10,500x. *A* transfers this stock to a new corporation *X* in exchange for preferred stock of *X* corporation with a par value of 10,000x and common stock of *X* corporation, which *A* then transfers to *A*'s son *B*.

(c) *A* owns 80 shares and his son *B* owns 20 shares of the common stock (the only stock outstanding) of *Z* Corporation. In a recapitalization described in section 368(a)(1)(E), *A* exchanges his 80 shares of common stock for 80 shares of new preferred stock of *Z* Corporation with a par value of 10,000x. *A*'s common stock had a fair market value of 10,000x.

SECTION 3. GENERAL APPROACH TO VALUATION

Under section 25.2512-2(f)(2) of the Gift Tax Regulations, the fair market value of stock in a closely held corporation depends upon numerous factors, including the corporation's net worth, its prospective earning power, and its capacity to pay dividends. In addition, other relevant factors must be taken into account. *See* Rev. Rul. 59-60. The weight to be accorded any evidentiary factor depends on the circumstances of each case. *See* section 25.2512-2(f) of the Gift Tax Regulations.

SECTION 4. APPROACH TO VALUATION——PREFERRED STOCK

.01 In general the most important factors to be considered in determining the value of preferred stock are its yield, dividend coverage and protection of its liquidation preference.

.02 Whether the yield of the preferred stock supports a valuation of the stock at par value depends in part on the adequacy of the dividend rate. The adequacy of the dividend rate should be determined by comparing its dividend rate with the dividend rate of high-grade publicly traded preferred stock. A lower yield than that of high-grade preferred stock indicates a preferred stock value of less than par. If the rate of interest charged by independent creditors to the corporation on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred stock should be correspondingly higher than the yield on high quality preferred stock. A yield which is not correspondingly higher reduces the value of the preferred stock. In addition, whether the preferred stock has a fixed dividend rate and is nonparticipating influences the value of the preferred stock. A publicly traded preferred stock for a company having a similar business and similar assets with similar liquidation preferences, voting rights and other similar terms would be the ideal comparable for determining yield required in arms length transactions for closely held stock. Such ideal comparables will frequently not exist. In such circumstances, the most comparable publicly-traded issues should be selected for comparison and appropriate adjustments made for differing factors.

.03 The actual dividend rate on a preferred stock can be assumed to be its stated rate if the issuing corporation will be able to pay its stated dividends in a timely manner and will, in fact, pay such dividends. The risk that the corporation may be unable to timely pay the stated dividends on the preferred stock can be measured by the coverage of such stated dividends by the corporation's earnings. Coverage of the dividend is measured by the ratio of the sum of pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends. *Standard & Poor's Ratings Guide*, 58 (1979). Inadequate coverage exists where a decline in corporate profits would be likely to jeopardize the corporation's ability to pay dividends on the preferred stock. The ratio for the preferred stock in question should be compared with the ratios for high quality preferred stock to determine whether the preferred stock has adequate coverage. Prior earnings history is important in this determination. Inadequate coverage indicates that the value of preferred stock is lower than its par value. Moreover, the absence of a provision that preferred dividends are cumulative raises substantial questions concerning whether the stated dividend rate will, in fact, be paid. Accordingly, preferred stock with noncumulative dividend features will normally have a value substantially lower than a cumulative preferred stock with the same yield, liquidation preference and dividend coverage.

.04 Whether the issuing corporation will be able to pay the full liquidation preference at liquidation must be taken into account in determining fair market value. This risk can be measured by the protection afforded by the corporation's net assets. Such protection can be measured by the ratio of the excess of the current market value of the corporation's assets over its liabilities to the aggregate liquidation preference. The protection ratio should be compared with the ratios for high quality preferred stock to determine adequacy of coverage. Inadequate asset protection exists where any unforeseen business reverses would be likely to jeopardize the corporation's ability to pay the full liquidation preference to the holders of the preferred stock.

.05 Another factor to be considered in valuing the preferred stock is whether it has voting rights and, if so, whether the preferred stock has voting control. See, however, Section 5.02 below.

.06 Peculiar covenants or provisions of the preferred stock of a type not ordinarily found in publicly traded preferred stock should be carefully evaluated to determine the effects of such covenants on the value of the preferred stock. In general, if covenants would inhibit the marketability of the stock or the power of the holder to enforce dividend or liquidation rights, such provision will reduce the value of the preferred stock by comparison to the value of preferred stock not containing such covenants or provisions.

.07 Whether the preferred stock contains a redemption privilege is another factor to be considered in determining the value of the preferred stock. The value of a redemption privilege triggered by death of the preferred shareholder will not exceed the present value of the redemption premium payable at the preferred shareholder's death (i.e., the present value of the excess of the redemption price over the fair market value of the preferred stock upon its issuance). The value of the redemption privilege should be reduced to reflect any risk that the corporation may not possess sufficient assets to redeem its preferred stock at the stated redemption price. See .03 above.

SECTION 5. APPROACH TO VALUATION——COMMON STOCK

.01 If the preferred stock has a fixed rate of dividend and is nonparticipating, the common stock has the exclusive right to the benefits of future appreciation of the value of the corporation. This right is valuable and usually warrants a determination that the common stock has substantial value. The actual value of this right depends upon the corporation's past growth experience, the economic condition of the industry in which the corporation operates, and general economic conditions. The factor to be used in capitalizing the corporation's prospective earnings must be determined after an analysis of numerous factors concerning the corporation and the economy as a whole. *See* Rev. Rul. 59-60, at page 243. In addition, after-tax earnings of the corporation at the time the preferred stock is issued in excess of the stated dividends on the preferred stock will increase the value of the common stock. Furthermore, a corporate policy of reinvesting earnings will also increase the value of the common stock.

.02 A factor to be considered in determining the value of the common stock is whether the preferred stock also has voting rights. Voting rights of the preferred stock, especially if the preferred stock has voting control, could under certain circumstances increase the value of the preferred stock and reduce the value of the common stock. This factor may be reduced in significance where the rights of common stockholders as a class are protected under state law from actions by another class of shareholders, *see Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), particularly where the common shareholders, as a class, are given the power to disapprove a proposal to allow preferred stock to be converted into common stock. See ABA-AIL Model Bus. Corp. Act, Section 60 (1969).

SECTION 6. EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 59-60, as modified by Rev. Rul. 65-193, 1965-2 C.B. 370 and as amplified by Rev. Rul. 77-287, 1977-2 C.B. 319, and Rev. Rul. 80-213, 1980-2 C.B. 101, is further amplified.

Lesson 8

Valuation of Closely Held Corporations – Analysis and Application of Data

Contents

Introduction

In Lesson 7, you learned that the three general factors used in valuation of a closely held business are the actual sales of the interest being valued, earnings, and book value.

While valuation of a closely held corporation (CHC) has been primarily associated with estate and gift taxes, valuation of CHCs arise in many income tax situations such as charitable contributions, divorce settlements or allocation of purchase price to assets in the sale of a CHC. Whether for income tax or estate and gift tax purposes, the principles of valuation remain the same. The essential valuation principles are set forth in Rev. Rul. 59-60[xxvi] and apply to income tax, as well as estate tax situations.

Because the best way to learn how to value a CHC is to actually do it, the remainder of this lesson lays out a hypothetical case study for Adam Packing Company. Your job is to analyze the facts of the case, applying the principles of Rev. Rul. 59-60, and to determine the fair market value (FMV) of the company. Remember that valuation is not an exact science, and therefore, no one number will exactly reflect value.

The problem is laid out with each section referring to a specific portion of Rev. Rul. 59-60 (**Exhibit 7-1** from Lesson 7). The facts of the case will then be presented to you along with a series of questions that should be answered, based upon the referenced section of the ruling and the facts given. At the end of each section, a space has been allotted for your answers to the questions, additional notes and comments.

Objective

At the end of this lesson, you will be able to apply the valuation factors listed in Rev. Rul. 59-60 to a specific fact pattern.

Statement of the Issue

On December 26, 1991, Steve Anson, the taxpayer, donated 6,400 shares of Adam Packing Company stock to a qualified charitable organization.

The gift has been reported on Steve Anson's Schedule A of the Form 1040 as a charitable contribution valued at $919 per share. The taxpayer's return value is based upon book value per share, as of November 30, 1991.

The examining agent recommended a value of $100 per share. The agent's value was based upon the actual sales price of the corporate stock.

What is the FMV on December 26, 1991, the date of the gift of 6,400 shares of common stock of Adam Packing Co., donated by Steve Anson to a qualified charitable organization?

Extract

Rev. Rul. 59-60
Section 4 Factors to Consider

Section 4.01

.01 It is advisable to emphasize that in the valuation of stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as relevant factors affecting the fair market value should be considered. The following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

* * * * *

Section 4.02

.02 The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization, but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products and services, its operating investment assets, capital structure, plant facilities, sale's records and management; all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

* * * * *

Facts of the Case:

The Adam Packing Company was incorporated in Iowa in 1928 and is in the meat packing and processing business. It operates two large meat packing plants in Iowa and a subsidiary has a meat packing plant in California. It produces primarily beef, lamb and pork meat products and by-products such as animal and plant foods and hides. The company leases several hundred railroad refrigerator cars and does its own purchasing, slaughtering and marketing of fresh and processed meats.

The capital stock of the company consists of the following classes:

Adam Packing Company Capital Stock		
Classes	**Shares**	**Par Value**
6% Cumulative Preferred	1,000	$100.00
Common Stock	32,000	100.00

As of the valuation date, all of the above shares were outstanding except for 100 shares of the common stock held by the corporation as treasury stock.

The preferred stock is nonvoting until dividends are five years in arrears. There are no accumulated dividends payable to preferred stockholders as of the valuation date.

The two classes of stock are held by members of the Anson and Long families. Most of the voting common stock is owned by the Anson group.

The donor, Steve Anson, was the corporation president at the time of the gift. His father had founded the original business from which the present corporation has evolved. Two sons and a nephew of Steve have been active in the firm since the end of World War II. His oldest son, Stephan, was assistant vice-president in charge of production at the time of Steve's gift and the nephew, Larry, was sales manager.

Questions:

1. Why is it important to understand the nature of the business and the history of the particular enterprise?

2. What if none of the managers of the company are family, but the corporation is family controlled? How does this change your analysis?

Economic Outlook

Extract

Rev. Rul. 59-60
Section 4.01

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

*   *   *   *   *

Section 4.02

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absences of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance or competent management might be employed on the basis of the consideration paid for the former manager's services. These or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

*   *   *   *   *

Facts of the Case:

The economic outlook for the meat packing industry at the date of the gift was ascertained from ***Standard and Poor's*** current analysis of the industry (dated September 9, 1991). The comments are paraphrased below.

- With large cattle marketing in the final half likely to offset a prospective year-to-year dip in hog slaughter, overall sales of the meat packers are expected to improve in the fiscal year ending October 31, 1991.

- The first half improvement suggests better full-year profit margins for meat packers. The highly favorable first half assures meat packers of substantially higher earnings in 1990-1991.

- Except for animals bought for stocking and feeding purposes, all livestock shipped to markets are purchased by packers and immediately slaughtered. Further, most fresh meat is sold promptly to avoid excessive shrinkage. Between 1980 and 1990, annual per capita consumption of meat rose 25.3 pounds to 207.3 pounds.

- The characteristically narrow profit margins of meat packers reflect competitive bidding for livestock supplies. Also, the percentage of sales carried through by domestic meat packing companies to net income has rarely exceeded two percent.

- The inherent uncertainties of the industry, together with substantial capital leverage and narrow margins, make shares of the meat packing companies' common stocks highly speculative. Price/earnings ratios normally are low.

Question:

Why is it important to understand the economic outlook, in general, and the outlook of the specific industry, in particular?

Financial Condition

Extract

Rev. Rul. 59-60
Section 4.01

(c) The book value of the stock and the financial condition of the business.

* * * * *

Section 4.02

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such non-operating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preferences as to dividends, and (3) preference as to assets in the event of liquidation.

* * * * *

Quick References

Book Value = Assets – Liabilities

Book Value per Share = $\dfrac{\text{Book Value}}{\text{Shares of common stock outstanding}}$

Current Assets are cash and those items readily convertible into cash In a short period of time (generally, including inventory).

Quick Assets are cash, marketable securities and accounts receivable.

Current Liabilities are liabilities payable within one year.

Long-term Liabilities are liabilities payable in **more** than one year.

Current Ratio = $\dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

Quick Ratio = $\dfrac{\text{Quick Assets}}{\text{Current Liabilities}}$

When computing book value per share, equity attributable to other classes of stock is excluded. Be careful, when determining book value per share, to use only those shares of stock both **issued and outstanding.**

Retained Earnings are undistributed past earnings.

Paid-in Capital is the price paid for the stock in excess of stated or Par value.

Reserve for Contingencies is an amount set aside from retained Earnings for contingencies (e.g., product liability lawsuit).

Facts of the Case:

The company operates on a fiscal year ending November 30. A condensed balance sheet as of November 30, 1991 is shown below.

Adam Packing Company
Balance Sheet
as of November 30, 1991

Current Assets		
Cash on hand and in bank		$ 3,930,000
Municipal and U.S. Bonds (FMV $4,000,000)		3,200,000
Receivables (net reserve of $35,000)		6,800,000
Inventories (LIFO method)		9,580,000
Prepayments		150,000
Total Current Assets		$23,660,000
Fixed and Other Assets		
Investment in subsidiary (FMV $1,500,000)		100,000
Plant, Equipment and Machinery	$14,140,000	
Less: Reserve for Depreciation	3,690,000	10,450,000
Other Assets		20,000
Total Assets		$34,230,000
		=========
Current Liabilities		
Accounts Payable		$ 2,850,000
Taxes Payable		1,950,000
Total Current Liabilities		$ 4,800,000
Long-Term Liabilities		-0-
Total Liabilities		$ 4,800,000
		=========
Shareholder's Equity		
6% Preferred Stock (1,000		

shares) $
100,000
Common stock (32,000 shares)
$ 3,200,000
Less: Treasury Stock (100
shares) 10,000
3,190,000
Retained Earnings
24,540,000
Paid in Capital
1,100,000
Reserve for Contingencies
500,000
Total Shareholder's Equity
$29,430,000
Total Liabilities and Equity
$34,230,000

=========

Experience with receivables indicates that the present reserve is adequate. Inventories would be $11,000,000 under the FIFO method of accounting for inventory. The plant, equipment and machinery (including real estate) has a FMV of $11,450,000.

The taxpayer, Steve Anson, valued the gifted shares on his tax return at book value, computed as follows:

Book Value of Gifted Shares	
Total Shareholder's Equity (above)	$29,430,000
Less Preferred Stock	100,000
	$29,330,000
Divided by Common Stock Shares	29,330,000
Outstanding (32,000 – 100)	31,900
Book Value per Share (rounded)	**$919**
	====

On the other hand, "tangible net worth at market" or "adjusted book value" is computed as follows:

Adjusted Book Value of Gifted Shares		
Total Shareholders Equity (above)		$29,430,000
Less Preferred Stock		100,000
Net Worth of Common Stock		$29,330,000
Adjustments:		
Municipal and U.S. Bonds:		
(FMV – BV)		
(4,000,000 – 3,200,000)	800,000	
Inventories:		
(FIFO – LIFO)		
(11,000,000 – 9,580,000)	1,420,000	
Investment in Subsidiary:		
(FMV – BV)		
(1,500,000 – 100,000)	1,400,000	
Plant, Equipment and Machinery:		
(FMV – BV)		
(11,450,000 – 10,450,000)	1,000,000	4,620,000
Total Adjustments		**$33,950,000**
		=========
		$33,950,000
Divided by Common Stock Outstanding		31,900
Per share tangible net worth at market (adjusted book value)		1,064

	====

The Adam Packing Company current ratio is as follows:

Current Ratio			
Current Assets / Current Liabilities	$23,660,000 / $ 4,800,000	=	4.9

Similarly, the quick or liquid ratio is computed as follows:

Quick Ratio		
(Cash) + (Bonds) + (Receivables) / (Current Liabilities)	=	
$3,930,000 + 3,200,000 + 6,800,000 / $4,800,000	=	2.9

Questions:

1. What conclusions can be drawn from the balance sheet?

2. What additional information would you want relative to the balance sheet?

3. Which year's balance sheet do you use, the year of the valuation or the prior year?

4. Why would you look at the quick ratio and the current ratio?

Earning Capacity

Extract

Rev. Rul. 59-60
Section 4.01

(d) The earning capacity of the company.

* * * * *

Section 4.02

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; (6) adjustment to, and reconciliation with, surplus as stated on the balance sheet. With profit-and-loss statements of this charter available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently as a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely held stock, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resorting to arbitrary five- or ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes, depletion or depreciation; and interest.

* * * * *

Quick References
The earnings of a business have been held by many valuation authorities to be the essence of its FMV. Certainly, investors have a primary concern with the earning power inherent in the securities they are buying or selling. One of the most frequently used indicators of earning power of a business is the income statement. We have to analyze the income statement to understand the operating results of the company. Usually income statements for a five-year period are obtained for comparison purposes. Trends in net sales, operating expenses, various classes of expenses or income and net profit should be noted because this will indicate the company's progress in the period preceding the valuation date. Expenses should also be analyzed to determine whether certain items would excluded by a prospective purchaser. Examples of such items are excessive salaries paid to officers, charitable

contributions, excessive or insufficient rent paid to related parties, excessive or insufficient interest expense, or personal expenses paid by corporation.

Gross Profit Percentage
Gross Profit Sales

Earnings Per Share
Net income after tax (After adjustment for other classes of stock) Number of Shares

Facts of the Case:

The company's consolidated statement of income for fiscal years ended November 30, 1989 through 1991 follows:

Adam Packing Company

Income Statement
(In Thousands)

	1989	**1990**	**1991**
Net Sales	$290,000	$297,000	$312,500
Costs of Goods Sold	226,200	244,100	250,000
Gross Profit	$ 63,800	$ 52,900	$ 62,500
Total Administrative & General Expenses	$ 56,180	$ 43,700	$ 54,300
Net Income before Taxes	$ 7,620	$ 9,200	$ 8,200
Tax (at 50% rate)	$ 3,810	$ 4,600	$ 4,100
Net Income after Tax	$ 3,810	$ 4,600	$ 4,100*

*Note that net income in relation to sales is $4,100,000/$312,500,000 or 1.3 percent of net sales.

For the years 1982 through 1988, net sales and net income after taxes were as follows:

Sales and Income		
Fiscal Year Ended 11/30	Net Sales (1,000's)	Net Income After Taxes (1,000's)
1982	$180,100	$1,840
1983	191,200	1,980
1984	215,300	2,040
1985	212,300	1,910
1986	230,900	2,200
1987	281,000	2,350
1988	275,100	3,050

The five-year average earnings on common stock is computed as follows:

Average Earnings on Common Stock	
1987	$ 2,350,000
1988	3,050,000
1989	3,810,000
1990	4,600,000
1991	4,100,000
Total Earnings	$17,910,000
Less dividends on preferred Stock ($6,000/year x 5 years)	30,000
Net Earnings	$17,880,000

$$\frac{\text{Net Earnings}}{\text{Number of Years}} = \text{Total Average Earnings}$$

$$\frac{\$17{,}880{,}000}{5 \text{ Years}} = \$\ 3{,}576{,}000$$

$$\frac{\text{Total Average Earnings}}{\text{Shares of Common Stock}} = \text{Average Earnings Per Share}$$

$$\frac{\$3{,}576{,}000}{31{,}900 \text{ Shares}} = \$112\text{/Share (rounded)}$$

Fiscal year 1991 earnings per common share is computed as follows:

Earnings Per Common Share	
Total net income after tax	$ 4,100,000
Less dividends on P/S	6,000
Total Earnings	$ 4,094,000

$$\frac{\text{Total Earnings}}{\text{Shares of Common Stock}} = \text{Earnings/Share}$$

$$\frac{\$4{,}094{,}000}{31{,}900 \text{ Shares}} = \$128\text{/Share (rounded)}$$

Questions:

1. What do sales tell you?

2. Why do you obtain more than one year's income statements?

3. What is "earnings per share" used for?

4. What happens when ten-year average earnings are used instead of five-year average earnings in a "growth industry"?

5. How do unreasonable salaries impact on valuation?

6. How does the LIFO method of inventory impact on the income statement?

Dividend Paying Capacity

Extract

Rev. Rul. 59-60
Section 4.01

(e) The dividend-paying capacity.

* * * * *

Section 4.02

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition.

Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends.

* * * * *

Quick References
The actual return on a stockholder's investment in a corporation is measured by the dividends received. Dividend payments out of current earnings make up the true yield realized by the stockholder. There is ambiguity in the phrase "dividend-paying capacity." Just how is this "capacity" to be determined? The corporation's earnings are the initial decisive factor in setting

its dividend-paying capacity. There are, however, other important elements in the picture.

The need for surplus funds for plant expansion or improvement, or the development of new product research, for example, are valid reasons for curbing dividends, and also for reducing our estimate of the company's capacity to pay dividends. A helpful device in analyzing this factor is to look at the experience in the industry as to dividends paid. Stated simply, we will study the dividend payout ratios of a comparable cross section of the industry. This should provide us, in many instances, with a fair indication of the percentage of available earnings which the particular industry pays out in annual dividends.

The advantage of this approach is that we have tangible support for the determination of true dividend-paying capacity.

$$\text{Pay-out Ratio} = \frac{\text{Dividends}}{\text{Earnings}}$$

$$\text{Yield} = \frac{\text{Dividends}}{\text{Price}}$$

Yield is the rate of return on an investment.

Facts of the Case:

For the years 1982 through 1991, Adam Packing Company has paid the following dividends:

Dividends		
Year	Dividends	Dividends Per Share
1982	$319,250	$10.00
1983	319,250	10.00
1984	319,250	10.00
1985	478,875	15.00
1986	478,500	15.00
1987	638,000	20.00
1988	638,000	20.00
1989	638,000	20.00
1990	957,000	30.00
1991	638,000	20.00

An analysis of the comparable companies shows the following statistics on current year's dividends:

Net Earnings Paid as Dividends		
	Payout as %	**Yield**
Rowan	43%	4.1%
Madison	29%	4.0%
Jenkins	30%	4.2%
Dawson	38%	3.5%
Branch	20%	2.7%
Average Yield	32%	3.7%

The above dividend information suggests that Adam Packing Company's common shares may be valued as follows:

Valuation of Common Shares Based on Dividends	
Current Year's EPS	$128
Times average payout of Comparable companies	x .32
Estimated "Dividend Paying Capacity" per share (rounded)	$ 41

$$\frac{\text{Dividend Paying Capacity per Share}}{\text{Average Yield of Comparable Companies}} = \text{Estimated FMV/Share Based on Dividend Yields of Comparable Publicly Traded Companies}$$

$$\frac{\$41}{.037} = \$1{,}108$$

Caveat: Keep in mind that Adam Packing Company has a dividend paying capacity of $41 per share, but it is actually paying only $20 per share. Based on **actual** dividends, the indicated FMV is $20 per share divided by .037 or $541 per share (rounded).

Question:

Do you think dividends paid or dividend-paying capacity is more significant? Why?

Sales of the Common Stock

Extract

Rev. Rul. 59-60
Section 4.01

(g) Sales of the stock
and the size of the block
of stock to be valued.

* * * * *

Section 4.02

(g) Sales of stock of a closely held corporation should be carefully investigate to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon consideration of all the evidence. Although it is true that a minority interest in an unlisted corporation is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

* * * * *

Facts of the Case:

There is no record of any sales of the preferred stock. The following schedule lists the most recent sales of the common stock as shown by the corporate records:

Sales of Stock			
Date	**Shares**	**Price/Share**	**Seller**
Jan. 18, 1991	20	$100.00	A.J. Essex
Sept. 15, 1991	30	100.00	Bob Titus
Aug. 19, 1991	10	100.00	Bob Titus
May 4, 1991	15	100.00	A.J. Essex
Dec. 2, 1991	25	100.00	Mary Huron

The purchaser in all of the above transactions was the corporation. All sellers are employees or officers of the company.

All sales were made pursuant to an agreement which required the shareholders to first offer to sell their stock to the company for par value. The company has always accepted the offers made.

Based upon the above sales, the examining agent determined that the FMV of the common shares, for the purpose of the claimed charitable deduction, is $100.00 per share.

Question:

Why are the above sales of common stock so significant?

Comparables

Extract

Rev. Rul. 59-60
Section 4.01

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

* * * * *

Section 4.02

(h) Section 2031(b) of the Code states, in effect, that in valuing unlisted securities, the value of stock or securities of corporations engaged in the same or similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stock actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their line of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

*   *   *   *   *

Quick References
1. Where to look for Comparables. There are a number of excellent sources and reference services which provide the security analyst with all needed background market and financial data. Two kinds of data are used to make a comparative analysis – market information and financial information. Market data disclosing stock or bond prices and volume of trading on a daily basis are readily attainable in the ***Wall Street Journal*** or comparable sources. Financial data can be found in ***Moody's Manuals*** and ***Standard & Poor's Services***.
2. What is a Comparable? Comparability is a question of degree. Generally, the most important factor to be considered in selecting your comparables is line of business activity.
3. Why find Comparables? The reason it is important to find comparable sales is to determine what price your company's stock would be selling for if it were offered in an open market.
4. Ratios to be used with Comparables: Price-earning Ratio: $$\text{P/E Ratio} = \frac{\text{Mean price at which stock is traded on valuation date}}{\text{Earnings*}}$$ *Earnings can be last year's earnings or average of number of year's earnings.

Price-book Value Ratio:

Mean price at which stock
P/VB =
is traded on valuation date

Book Value

(or adjusted Book Value)

Dividend Yield =
Annual Dividend

Mean Price, etc.

The P/E ratio tells us the earnings multiple at which the stock is Trading. Capitalization rates are usually expressed in percentage, but are the inverse of the P/E ratio (i.e.: earning/price).

Facts of the Case:

The administration file listed 13 companies in the meat packing industry that are publicly traded. For the purpose of this example, only five comparable companies (with pertinent data) are listed below:

Comparable Companies

Company	**Last Year's Sales (000 Omitted)**	**Price/ Last Year Earnings Ratio**	**Price/ Last 5-Year Earnings Ratio**	**Current Ratio**
Rowan	$329,604	10.9	*	1.7
Madison	411,827	7.3	10.7	2.0
Jenkins	454,333	7.1	21.1	2.1
Dawson	295,966	11.1	15.3	3.4
Branch	256,817	7.6	11.7	2.6
Average		**8.8**	**14.7**	

*One of Rowan's last five years was a loss year.

The average P/E per share for the last year shown above suggests the following tentative value for Adam Packing Company Common Stock:

Valuation of Common Shares Based on Current Price/Earnings Ratios of Comparables	
1991 Earnings per Share	$ 128
Times P/E Ratio of Comparables	x 8.8
Estimated value based upon P/E Ratio of publicly traded comparable Companies (rounded)	$ 1,126
	=====

Similarly, the "price/last five-year earnings ratio" suggests a value of $1,646/share.

Valuation of Common Shares Based on Five-Year **Price/Earnings Ratios of Comparables**	
Five-year average earnings per share	$ 112
Times average P/E ratio of comparables	x 14.7
Estimated value based on five-year P/E ratio of publicly traded comparable companies (rounded)	$1,646
	=====

Question:

What factors should be considered in the selection of a "comparable company"?

Analysis

Our analysis tells us that this is a strong company. The income statements show progressive growth in sales and income. The quick ratio (2.9) is exceptionally good, as is the current ratio (4.9). There is good continuity of management with two younger members of the family in top management positions. The ten-year sales and profit history indicates an effective going concern.

The industry is both stable and progressive, with per capita meat consumption steadily rising and overall sales expected to increase. Our company's profit margin is consistent at about 1.3 percent of sales. Note that the industry average rarely exceeds 2 percent.

The upward trend in profits is clearly shown in the previous earnings schedules. In view of the continued increase in profits, the latest years' earnings are believed to be most indicative of future earnings.

In a closely held corporation, such as Adam Packing Company, where a family group controls the company's policies, the actual dividend payments are secondary in importance to the dividend paying <u>capacity</u> of the business.

Summary of Findings

The most significant factors may be summarized as follows:

1. The stock is a minority interest in a closely held corporation and it is lacking in ready marketability.

2. The book value is $919 per share as reported on the return. The adjusted book value (i.e., tangible net worth at market) is $1,064 per share.

3. Sales and net earnings have been for the most part moving consistently upward.

4. The latest year's earnings were $128 per share and the last five years' earnings were $112 per share.

5. Stocks of comparable companies were selling for an average of 8.8 times current earnings and 14.7 times the last five years' average earnings.

6. The above price/earnings ratios applied to the subject company's earnings suggest values of:

    a. $1,126 per share based on current earnings, and

    b. $1,646 per share on five-year average earnings.

7. The average dividend yields show comparables centered around the 3.5 percent level. This figure applied to the current year's dividend capacity of Adam Packing Company suggests a FMV of $1,108 per share.

    Caveat: The above analysis does not consider discounts for a minority interest and lack of marketability. In the next lesson, you will learn about discounts.

    Question:

    Meanwhile, prior to any such discounts, what do you think is a reasonable range for the FMV of Adam Packing Company stock?

    Consider the following methods:

1. Book Value

2. Adjusted Book Value

3. Comparables

   EPS for 1 year

   EPS for 5 years

4. Dividend Yield Method

Summary

This lesson discusses the application of the general principles of valuation to a hypothetical closely held corporation, namely, the Adam Packing Company case. In the next lesson, you will learn about discounts for minority interests and lack of marketability.

Lesson 9

Discounts

Contents

Answers to Exercises

Introduction

In Lessons 7 and 8, you learned basic valuation methods for closely held corporations whose stock is not publicly traded. In this lesson, you will learn when it is appropriate to reduce the value of closely held stock, that is, to "discount" it, because it is not marketable or because the stock represents a minority interest.

Objectives

At the end of this lesson, you will be able to:

1. Explain the concept of a lack of marketability discount and apply it to a specific fact situation.

2. Explain the concept of a minority interest discount and apply it to a specific fact situation.

3. Explain the concept of key person discount and apply it to a specific fact situation.

4. Analyze a specific fact situation for hidden discounts.

Hypothetical Willing Buyer – Willing Seller

We discussed the definition of fair market value in several earlier lessons. The definition of fair market value requires a hypothetical willing buyer - willing seller; **no assumptions should be made about who will buy the stock to be valued**. The regulations, Rev. Rul. 59-60 and case law require a truly hypothetical willing seller and willing buyer. As you learned in Lessons 6 , 7 and 8, closely held stock is not the equivalent of stock publicly traded on an exchange. The "discounts" discussed in this lesson are an attempt by appraisers and the courts to value closely held stock in a way which accounts for these differences.

For many years, the Service's position was that a minority discount is not allowable for an individual stockholder when the corporation is controlled by members of the individual's family. This position was described in Rev. Rul. 81-253, 81-2 C.B. 187. The Courts have uniformly rejected this position. The leading cases in this area are Estate of Andrews v. Commissioner,[xxvii] Estate of Bright v. United States,[xxviii] and Propstra.[xxix] Further, in Minahan,[xxx] the taxpayer was awarded attorneys' fees in a case where the Government "persists in the face of the Estate of Andrews and its progenitors [to espouse a family attribution approach]."

As a result of this sound thrashing of the Service by the Courts, Rev. Rul. 93-12[xxxi] was issued which modifies the Service's position in this area. This ruling is reproduced in **Exhibit 9-1** [not included in this posting].

Lack of Marketability

Definition

Lack of marketability is defined as the absence of a ready or existing market for the sale or purchase of the securities being valued.

Investors prefer an asset which is easy to sell, that is, liquid. An interest in a closely held business is not liquid in comparison to most other investments.

Exercise 1

The majority shareholder of Pace Corporation died and left her 100 shares of stock to her daughter. In order to establish the value of these shares for estate tax purposes, a comparable corporation, King Corporation, was found which is listed on the New York Stock Exchange. It has the same type of industry line, sales, earnings, assets and management as Pace which is a private corporation and not listed on the stock exchange. King stock sells at $10 per share. Is the value of 100 shares of Pace the same as the value of 100 shares of King?

In Central Trust Co. v. United States,[xxxii] the Court of Claims stated:

Extract

Central Trust Co. v. United States

* * * * *

* * *It seems clear, however, that an unlisted closely-held stock of a corporation * * *, in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public.

* * * * *

The Courts have followed this principle. This discount is meant to act as a means of equalizing an investment in closely held stock with an investment in publicly traded stock.[xxxiii]

Extract

Estate of Andrews, 79 T.C. 938, page 953.

* * * * *

> * * *even controlling shares in a nonpublic corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock.* * *

* * * * *

Determining the Percentage Discount

As an appeals officer, it will often be necessary for you to determine the amount of the marketability discount.

There are many factors to consider:

1. restrictions imposed by the corporation,

2. restrictions imposed by state or federal law,

3. costs to sell the stock:

   a. brokers commission for the sale of the entire business when sold locally,

   b. registration and distribution costs,

   c. underwriters commissions,

4. comparison of market prices of publicly owned companies in a similar business.

Note: Read Pratt Chapter 15, pages 336 to 348 for a discussion of the studies available to determine a marketability discount.

Evaluating the Studies

When an appraisal report has a discount factor in the computation based on a particular study, you need to determine if the corporations in the study are similar to the one you are considering.

For example, the Gelman study discussed on page 338 of the Pratt book involved the prices paid for restricted securities by four closed-end investment companies. Your case involves the value of stock in a corporation which operates a local grocery store. Would you give the Gelman study a lot of weight in computing the marketability discount?

In Berg,[xxxiv] the Government expert's opinion on the marketability discount was sustained. The Tax Court found the expert did a very thorough analysis of the comparables.

Extract

Berg, 61 T.C.M. 2949, page 2,958

*   *   *   *   *

* * * examines the specific factors which determine the amount of a discount for lack of marketability and applies these factors to the instant case. Because of his analysis of specific factors related to the value of the decedent's interest…[respondents expert's] methodology is convincing and superior to that of petitioner's expert witnesses * * *

*   *   *   *   *

Note: Read the Berg decision in Exhibit 9-2 [not included in this posting]**.**

Exercise 2

What are the specific factors considered by the Court in Berg?

In Mandelbaum, 69 TCM 2852 (1995-255…Dec. 50,687) the Tax Court identified a number of factors that should be considered in estimating a marketability discount for the stock of a closely held company.

Read Mandelbaum decision in Exhibit 9-3 [not included in this posting]**.**

Minority Interest

Definition

A minority interest in a corporation is the ownership of an amount of stock which does not enable the holder to exercise control. This is generally ownership of less than 50 percent.

The lack of control of a minority interest makes it less attractive to investors, who are not necessarily willing to pay the allocable value of the stock. The reduction for what a willing buyer would pay for an interest with no control is called a minority discount.

You should be aware that a **numerical** minority or majority interest may not represent **actual** control.

- State law or the articles of incorporation may require a specific percentage to make decisions or compel liquidation.

- Pratt indicates in a corporation with three shareholders, each owning one third of stock, no one has controlling interest.

- An individual who owns a numerical minority, may, based on the particular facts, be exercising actual control and making all decisions.

- A minority block of stock may be a swing vote.

____

Exercise 3

In the King Corporation, Johnson and Wiley each own 45 percent of the stock. Harcum owns 10 percent of the stock. Does Harcum own a minority interest?

____

Exercise 4

In the McHenry Corporation, John McHenry owns 30 percent of the stock. Thirty-five other shareholders each own 2 percent of the stock. Does John McHenry own a minority interest?

____

Determining the Percentage Discount

The most significant factor to consider is whether investment return (dividends and liquidation value) is dependent on decisions over which the minority shareholder has no control.

It is important to recognize that if the preliminary value is derived from comparables listed on an exchange or traded over the counter, no minority interest discount would be appropriate. This is so, because the price quotations for the publicly traded comparable companies are for lots of 100 shares, and as such, already reflect the fact that the shares are a minority investment.

Other factors to consider:

- liquid assets versus operating company

- low risk business versus high risk business

- size of the block of stock

- comparable sales of minority blocks versus majority blocks

Note: As we discussed in the marketability section, it is important to analyze whether studies of comparable sales are really comparable to your case.

Note: Read Pratt Chapter 14 for a more detailed discussion of the factors to consider and the methods of valuing a minority discount.

Range of Discounts

You may remember that Estate of Andrews, Estate of Bright and Propstra, were selected cases where discounts were allowed by the Courts. These cases indicate that the Courts have allowed discounts ranging from 10 percent to 65 percent for marketability and minority interest.

Pratt Chapter 15 concludes that the Courts have allowed marketability discounts below the amounts suggested by the empirical evidence. As an appeals officer, what do you think of Pratt's comments?

Exercise 5

Refer to the facts of Adam Packing in Lesson 8. The range of values that you determined in that lesson is $919 to $1,126 per share.

a. Is there a ready market for the shares?

b. Would any of the studies discussed in Pratt Chapter 15 be appropriate to use for Adam Packing? Why? Would another method be more appropriate?

c. Would a minority discount be appropriate for the shares?

d. Does the method you used to value the stock affect the amount of the minority discount?

Exhibit 9-4 [not included in this posting] contains a series of court cases cited with an explanation of the Court's basis for the discounts determined.

Duplication of Discounts

Valuation of Corporations

Frequently, one of the components used to compute the value of stock, such as a more liberal capitalization rate (which already allows an indirect discount), is selected because the stock is not marketable or represents a minority interest. The appraiser then claims a further discount.

You should review the method of computing the value of the stock as discussed in the earlier lessons and the appropriate capitalization rates for a particular size of business contained in the Ibbotson Study which was discussed in Lesson 1. Only if the capitalization rate or other valuation method is appropriate for the business **without regard** to marketability or minority interest, would an additional discount be appropriate.

Comparable Sales

As previously mentioned, comparable sales of listed stocks already represent a minority interest. If the stock in your case is valued based on the price/earnings ratios of comparable listed stocks or some other method using comparable listed stocks, an additional minority discount would not be appropriate.

Transactions Structured for Tax Benefits

Where the evidence shows that a transaction was structured to attain a minority discount solely for the tax benefits, the Courts generally have not allowed a minority discount. In other words, the courts are inclined to look for economic substance (or business purpose aside from the tax consequences).

In Murphy, the decedent's accountant periodically advised decedent to reduce her stock ownership below 50 percent. Eighteen days before her death, she made gifts of .88 percent of the stock to each of her two children, resulting in her ownership of 49.65 percent at her death.

Extract

Murphy, 60 T.C.M. 645, page 658

* * * * *

* * * [T]he facts in this case are extreme. Briefly, control was kept in and exercised continuously by the Murphy family, including decedent, followed by her children. Decedent implemented a plan 18 days before her death with the sole and explicit purpose to obtain a minority discount. We are aware of no case where a court has allowed a minority discount in this situation. * * *

* * * * *

Because the facts are extreme, the Murphy case does not have general application in many minority cases. But, if the facts do indicate a transfer was made solely to achieve a **numerical** minority without relinquishing any **actual** control, a minority discount would not be allowable.

Key Person

A key person is an individual whose contribution to a business is so significant that there is certainty that future earning levels will be adversely affected by the loss of the individual.

Exercise 6

Smith is the founder and sole owner of Smith Boatbuilding, Inc., a company that specializes in designing and building medium sized sailboats. Smith is an engineer and is personally responsible for several industry-acclaimed design innovations. Is Smith a key person? Why or why not?

Rev. Rul. 59-60 recognizes the fact that in many types of businesses, the loss of a key person may have a depressing effect upon value. Section 4.02(b) states:

Extract

Rev. Rul. 59-60
Section 4.02

* * * * *

* * * The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager.

Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

* * * * *

Some courts have accounted for this depressing effect on value by applying a key person discount. In determining whether to apply a key person discount certain factors should be considered:

1. Whether the claimed individual was actually responsible for the company's profit levels.

2. If there is a key person, whether the individual can be adequately replaced.

Though an individual may be the founder and controlling officer of a corporation, it does not necessarily follow that he or she is a key person. Earnings may be attributable to intangibles such as patents and copyrights or long-term contracts. Evidence of special expertise and current significant management decisions should be presented. Finally, subsequent years' financial statements should be reviewed to see if earnings actually declined. In many situations, the loss of a so-called key person may actually result in increased profits.

The size of the company, in terms of number of employees, is also significant. The greater the number of employees, the greater the burden of showing that the contributions of one person were responsible for the firm's earnings history.

Even where there is a key person, the possibility exists that the individual can be adequately replaced. Consideration should be given to whether other long-term employees can assume management positions. On occasion, a company may own key-person life insurance. The proceeds from this type of policy may enable the company to survive a period of decreased earnings and to attract competent replacements.

There is no set percentage or format for reflecting a key person discount. It is essentially based on the facts and circumstances of each case.

You may encounter situations where the discounts are hidden or obscured. Next, we cover some of the more common hidden discounts.

Hidden Discounts

Liquidation Expenses

The courts have never recognized components of liquidation expenses.

Capital Gains Tax

The taxpayer might take a deduction for prospective income tax liability, such as capital gains tax on unsold, but appreciated property, held by the corporation. This hidden discount might appear either in the calculation of the corporation's income stream or as a liability in the corporation's computation of adjusted book value.

The case law has indicated prospective capital gains tax and liquidation expenses are speculative and not includible in the valuation.[xxxv]

However, since the General Utilities doctrine has been revoked by statute (Tax Reform Act of 1986), a tax liability upon liquidation is not necessarily speculative.

General Utilities Doctrine

For 51 years, acquiring corporations could revalue the target corporation's assets to current fair market values, without paying a capital gains tax on the increase in the tax basis of target corporation assets (target corporation did pay ordinary tax on recapture of depreciation, ITC, etc.) under the General Utilities doctrine. The doctrine is based on a federal court case, General Utilities and Operating Co. v. Helvering.[xxxvi] Congress endorsed this doctrine by writing it into IRC §§ 311, 336 and 337.

The Tax Reform Act of 1986 repealed the General Utilities doctrine for liquidations after 1986, generally. This has the effect of increasing the tax on the sale of a corporation. If the election is made under IRC § 338 to assign cost to underlying assets, the target corporation has an immediate tax liability, due to recognizing current fair market value gain on the deemed sale of all assets. The only way to avoid this immediate tax is to forego the tax basis reorganization and to continue the target corporation on its old basis rather than on a new basis, that is, to continue the business of the target as a wholly owned subsidiary, rather than to liquidate it and merge it.

While, as noted above, since the repeal of the General Utilities doctrine, a tax liability upon liquidation is not necessarily speculative, in many instances, liquidation of the corporation cannot be contemplated. In a very typical circumstance, such as the valuation of a minority interest in a personal holding or real estate investment company, the holder of the minority interest cannot force the company into liquidation. As such, unless there is a reason to believe that the company is to be liquidated, based on available information, liquidation of the corporation cannot be contemplated and the deduction for capital gains tax should not be taken. In addition, the prospective capital gains tax expenses are considered speculative because unless liquidation of the corporation is imminent, the amount of the taxes or their incurrence at all, cannot be known with certainty because of the likelihood of changes in future tax laws. (See TAM 9150001.)

Example 1

Corporation L is formed in 1970 with $200,000 capital. Corporation L acquires capital assets, which have a current fair market value of $2,200,000 in 1995. Shareholders of Corporation L sell the stock of Corporation L to Corporation X for $2,200,000. Corporation X makes the IRC § 338 election.

	"With" General Utilities		"Without" General Utilities	
	Shareholder	Corporation L	Corporation L	Shareholder
Price	$2,200,000		$2,200,000	
Basis	(200,000)		(200,000)	$120,000[11]
Gain	2,000,000		2,000,000	(200,000)
Tax Rate	x 28%	N/A	x 34%	1,320,000
Tax	$560,000	-0-	$680,000	x 28%
				$369,600
Total Tax	$560,000			

Total Add'l Tax "Without" General Utililites				$1,049,600 $ 489,600
Net After Tax		$1,640,000[xxxvii]		$1,150,400

Does the taxpayer have a more valid argument to use discounts for Federal taxes?

Lack of Comparability

You may recall that it was emphasized in an earlier lesson, that use of an average P/E ratio for comparables, whether the average used is straight line or weighted average, or use of five-years average income for the subject may tend to distort value in cases where there is a definitive upward or downward income trend.

Example 2

Hope Corporation and Lane Corporation are alike in all respects except earnings trends shown below:

Year	Hope Earnings	Lane Earnings
1991	$ 500,000	$ 100,000
1992	400,000	200,000
1993	300,000	300,000
1994	200,000	400,000
1995	100,000	500,000
	$1,500,000 5 yrs	$1,500,000 5 yrs
Average Earnings	$ 300,000	$ 300,000
Shares Outstanding	10,000	10,000
5-Year Average EPS	$30	$30
Current EPS	$10	$50

It is evident that a prudent investor would not pay the same price for Hope Company as he would pay for Lane Company, in view of the opposite earnings trends of each corporation. If Hope stock is selling at $180 per share, the five years' average P/E ratio is:

Hope's Five Years' P/E Ratio

$\frac{\text{Price per Share}}{\text{Five Year EPS}} = \frac{180}{30} = 6$

The current P/E ratio is:

Hope's Current P/E Ratio
$\frac{\text{Price per Share}}{\text{Current EPS}} = \frac{180}{10} = 18$

Applying Hope's average five-years' P/E ratio to Lane Company, the value of the Lane stock is $180/share, the same value as Hope ($30 x 6).

Lane's Stock Value Based on Five Years' EPS and Hope's Five Years' P/E Ratio						
P/E Ratio	x	EPS	=	Price per Share
6	x	30	=	$180

Although one company has a downward earnings trend, and the other company has an upward earnings trend, both companies have the same value per share, using the five-years' average P/E ratio. Obviously, this is a distortion because the rate of growth and prospective earnings capacity are not reflected in the five-years earnings.

The distortion is clearly shown by applying the Hope Company's current P/E ratio to Lane Company.

Lane's Stock Value Based on Current EPS and Hope's Current P/E Ratio				
P/E Ratio	x	EPS	=	Price Per Share
18	x	50	=	$900

This example highlights the importance of considering the rate of growth and earnings trend in selection of the P/E ratios.

Use of Average-to-Average or Year-to-Year in Deriving Statistics

You should be careful that average statistics, or yearly statistics, are not used together in deriving formulas for valuation, in order to avoid distortion.

The distortion that results from application of an "average" ratio to "yearly" statistics, (or vice-versa) is shown by the following example.

Example 3

Athena Corp. is a comparable listed (public) corporation. Bard Corp. is the subject to be valued.

	Athens Earnings		Bard Earnings	
1991	$500,000 x 1 =	$ 500,000	$ 100,000 x 1 =	$ 100,000
1992	400,000 x 2 =	800,000	200 000 x 2 =	400,000
1993	300,000 x 3 =	900,000	300,000 x 3 =	900,000
1994	200,000 x 4 =	800,000	400,000 x 4 =	1,600,000
1995	100,000 x 5 =	500,000	500,000 x 5 =	2,500,000
		$3,500,000		$5,500,000
Divided by:		15		15
Average Earnings	______	233,333	_______	$ 366,666
Divided by Shares Outstanding	10,000	10,000	10,000	10,000
5-year Average EPS		$23.33		$36.66
Last Year EPS	$10		$50	

Athens stock sells for $60 per share, so the current P/E ratio is 6:1.

Athen's Current P/E Ratio

$$\frac{\text{Price per Share}}{\text{Current EPS}} = \frac{60}{10} = 6$$

The average P/E ratio for the five years is:

Athens' Five-Years’ P/E Ratio

Price per Share = 60 = 2.57

Five-Year EPS 23/33

Applying Athens' current P/E ratio to Bard's current earnings, the value for Bard stock is $300 per share.

Bard's Stock Value Based on Current EPS and Athen's Current P/E Ratio				
P/E Ratio	x	EPS	=	Price per Share
6	x	50	=	$300

Applying Athens' **average five-years'** P/E ratio to Bard Company's current earnings, the value of the Bard stock is $128.50/share.

Bard's Stock Value Based on Current EPS and Athens' Five-Years' P/E Ratio				
P/E Ratio	x	EPS	=	Price per Share
2.57	x	50	=	$128.50

Which method results in distortion? The second method results in distortion because an average ratio is being applied against current earnings.

Pyramiding

The taking of discounts at various levels of the valuation process that results in a much larger discount than the amount that is stated.

Example 4

Fairfield Co. was valued as of the date of transfer. Each asset was discounted 10 percent and then the total assets were discounted 30 percent. The examiner allowed only the overall 30 percent discount. The difference was computed as follows:

	Fairfield Company Discounts			
	FMV	**Discount**	**Total With Discount**	**Total Without Discount**

Marketable Securities	100,000 100,000 100,000	10% 10% 10%	90,000 90,000 90,000	100,000 100,000 100,000
Realty C/H Corp			270,000	300,000

Value of Corporation			81,000	90,000
Stated Discount 30%				
Adjusted Value			$189,000	$210,000

You can see how easy it is to apply individual discounts to various assets and then to further reduce the value by a cumulative discount.

Summary

In this lesson, you learned how and when to apply a variety of discounts to closely held stock.

In the next lesson, you will learn when a restrictive agreement or buy-sell agreement will fix the value of closely held stock.

Class Exercise

Titus Company has the following balance sheet:

TITUS COMPANY Balance Sheet December 31,19xx			
Assets		**Liabilities**	
Cash	$ 50,000	Payables	$ 10,000
Land	100,000	Dividends Payable	50,000
		Total Liabilities	60,000
		Common Stock	90,000
Total Assets	$150,000	**Total Liabilities & Equity**	$150,000

The income statement is as follows:

TITUS COMPANY	
Balance Sheet	
December 31, 19xx	
Farm Income	$50,000
Net Income	$50,000

Additional Facts:

- The FMV of the land is $900,000.
- Comparable companies are trading at ten times earnings.
- Investment in comparables is resulting in a yield of four percent.
- The dividends payable of $50,000 is equal to the cash available for Titus. It is unlikely that a publicly traded company would pay that amount of dividends. In this case, the standard payout for the industry is usually 30 percent of earnings in dividends.

Anne Titus was the founder of the corporation and owned 25 percent of the shares of Titus Company with three other unrelated individuals. Ann has died and the shares need to be valued for estate tax purposes.

Questions:

Compute the value of the Titus Company using the following methods:

1. Net Asset Value Method
2. Dividend Yield Method
3. Earnings Method

What is the value of Anne's 25 percent interest? Explain your answer.

Answers to Exercises

Exercise 1

King Corporation is a corporation listed on the stock exchange. It has the same type of industry line, sales, earnings, assets and management as Pace Corporation, which is not listed. King stock sells at $10 per share. Is the value of 100 shares of Pace Corporation the same as the value of 100 shares of King Corporation?

Answer

No, because there is no ready market for the Pace Corporation stock.

Exercise 2

What are the specific factors considered by the Court in Berg?

Answer

The IRS appraiser used the Moroney Study and applied the following specific factors to the facts of the subject case:

1. Extent of minority interest,

2. Quality and risk factors of the real estate or equity,

3. Company organization.

Exercise 3

In the King Corporation, Johnson and Wiley each own 45 percent of the stock. Harcum owns 10 percent of the stock. Does Harcum own a minority interest?

Answer

Harcum probably owns a minority interest in this situation.

Exercise 4

In the McHenry Corporation, John McHenry owns 30 percent of the stock. Thirty-five other shareholders each own 2 percent of the stock. Does John McHenry own a minority interest?

Answer

Additional information about the McHenry Corporation is needed, but John McHenry probably does not own a minority interest.

Exercise 5

Refer to the facts of Adam Packing in Lesson 8. The range of values that you determined in that lesson is $919 to $1126 per share.

a. Is there a ready market for the shares?

Answer

There is no ready market for the shares to be valued – these shares are a minority interest also.

b. Would any of the studies discussed in Pratt Chapter 15 be appropriate to use for Adam Packing? Why? Would another method be more appropriate?

Answer

The SEC Institutional Investor study, the Gelman study, the Trout study, the Moroney study, the Maher study, the Standard Research Consultants and the Willamette Management Associates study for years 1981 through 1984 all involve primarily purchases by investment companies.

Willamette Management (Pratt, pages 344-348) does involve an operating company, but if the sale was within six months of public offering, the seller surely knew of the impending sale. Is this really an arms-length transaction?

c. Would a minority discount be appropriate for the shares? Does the method you used to value the stock affect the amount of the minority discount?

Answer

The shares involve a minority interest, but if the method used was P/E ratios of comparable publicly traded companies, an additional discount would not be appropriate.

d. Does the method you used to value the stock affect the amount of minority discount?

Answer

Yes. A minority discount would be inappropriate if you valued the shares based on a comparison with publicly traded comparable companies.

Exercise 6

Smith is the sole owner and founder of Smith Boatbuilding, Inc., a company that specializes in designing and building medium size sailboats. Smith is an engineer and is personally responsible for several industry-acclaimed design innovations. Is Smith as key person?

Answer

> These facts point to the conclusions that Smith is probably a key person. However, ask yourself, "How old is he, how many other employees are there in the company, how active has he been recently?"

Lesson 10

Restrictive Agreements/
Buy-Sell Agreements

Contents

Introduction

In the last lesson you learned when a discount in the value of closely held stock is appropriate. In this lesson, you will learn circumstances where the value of closely held stock can be fixed by agreement of the stockholders.

Objectives

At the end of the lesson, you will be able to:

1. Explain the concept of a restrictive agreement or buy-sell agreement and apply it to a specific fact situation.

2. Determine whether the agreement has a bona fide business purpose.

3. Determine whether the agreement is a substitute for a testamentary device.

4. Determine whether the agreement applies in a gift tax case.

Restrictive Agreements/Buy-Sell Agreements

Restrictive agreements such as buy-sell agreements are entered into by the shareholders of a corporation to limit the transferability of their stock. They can also fix the value of those shares for Federal estate tax purpose. The effect of the agreement price depends on the circumstances.

Treas. Reg. § 20.2031-2(h)

Treas. Reg. § 20.2031-2(h), **Exhibit 10-1** [not included in this posting], states that an agreement price sill be disregarded unless:

1. agreement represents a bona fide business arrangement, and

2. it is not a device to pass decedent's shares to the natural object of his or her bounty (heir) for less than adequate consideration.

Types of Agreements

There are several types of restrictive agreements. There agreements and their effect on the valuation of the stock are summarized in **Exhibit 10-2** [not included in this posting].

Agreement Effective Only at Death

Little weight will be given to an agreement if the decedent is free to dispose of the stock at any price during his life. Before a restriction on a stock transfer will be given any consideration in the determination of stock value, the restriction must be both:

1. binding during life as well as at death, and

2. binding on the stockholder's estate or heirs after the stockholder's death.

Right of First Refusal

With this type of agreement, the owner of the interest is simply required to offer the interest at a designated price to either the other owners of the corporation or the corporation itself, upon the occurrence of a stated event. The owner of the interest need not offer the interest for sale. If it is offered for sale, the other parties are under no obligation to purchase. If they choose not to purchase the offered stock, the interest may then be sold to a third party.

This type of agreement is a factor to consider in valuing the stock, but it is usually not controlling, because the stockholder or the estate can control the timing of the sale or retain the stock if they wish.

The Purchase Option

This type of agreement differs from the right of first refusal in that the selling party **must** sell the interest if the purchasing party decides to purchase it. The purchasing parties are not obligated to exercise the option.

If the requirements of the regulations are met (as will be covered in more detail below) the value provided in the agreement will generally be binding.

Mandatory Buy-Sell Agreements

Note: Read Pratt, Chapter 28, pages 667 to 674, Formula Approaches, and 679 to 682.

This type of agreement imposes legal obligations upon the parties. The owner of the interest must sell it at a designated price upon the occurrence of a stated event and the other parties must buy the interest at that price.

When this type of agreement can be shown to be a bona fide business arrangement, the price set by the agreement will control the estate tax valuation.

Exercise 1

At his death, Jack Travis owned 30 percent of the stock of the Hayes Corporation. Five years before Travis' death, Travis and the other shareholders of Hayes entered into an agreement which provided in part:

1. If the shareholders of Hayes wish to sell their shares, they will offer the shares first to all the other shareholders for a period of 30 days. If the other shareholders do not buy the stock, it will be offered to the corporation for 30 days. If the corporation does not buy the stock, it may be offered to any third party for a period of six months.

2. At the death of a shareholder, the estate shall offer to sell the stock in the manner described above.

Upon the death of Travis, the estate sold his stock to the corporation for the price provided for in the agreement.

The corporation has always purchased the stock if it is ever offered for sale. Does the agreement price fix the value in the estate?

Answer

Business Purpose

As stated above, the agreement must represent a bona fide business arrangement. The following reasons have qualified as a bona fide business purpose:[xxxviii]

1. Maintenance of ownership and control within the family, and

2. Providing continuity of management.

Testamentary Device

The regulations and the case law indicate that a bona fide business purpose sometimes, is not enough. The taxpayer must also show that the agreement is not a device to pass the stock to the individuals who would be the beneficiaries of the estate, for less than adequate consideration.

The following factors should be considered in the determination of whether an agreement is a testamentary device:

1. Relationship of the parties,

2. Whether the price approximates fair market value at the time the agreement was executed,

3. Restrictiveness of the agreement.

Exercise 2

The agreement for the sale of Hayes stock discussed in Exercise 1, further provides:

3. The purpose of this agreement is to provide continuity of management.

The stockholders of Hayes are:

- Jack Travis and his wife
- Tom and Andrew Travis, Jack's brothers and their wives
- Jack's two sons
- Tom's three sons
- Andrew's daughter
- Three unrelated employees

a. Does this agreement have a bona fide business purpose or is it a testamentary device?

Answer

b. Is there a stronger argument for a testamentary device if the shareholders were just Jack and his two sons?

Answer

Reasonableness of the Agreement Price

There are two other factors that should be considered when deciding if an agreement has a bona fide business purpose and is not a testamentary device. These factors are:

1. Reasonableness of the agreement price, and

2. Reasonableness of the method of computing the agreement price. This computation method should be contained in the agreement.

The reasonableness of the agreement price is determined at the time of the agreement, not at the evaluation date.

Exercise 3

The Hayes agreement described in the earlier exercises, provides that the agreement price will be equal to adjusted book value.

a. Is this a reasonable price?

   Answer

b. What other facts do you need to know?

   Answer

Agreements Followed Consistently

Where the terms of the agreement have not been consistently followed by all the parties, the agreement will not control the value for tax purposes. See St. Louis County Bank, 82-1 U.S.T.C. 13,459 and Estate of Lenheim, T.C. Memo 1990-403.

Additional Discounts

None of the cases upholding a restrictive agreement price have allowed any other discounts.

Gift Tax Application

The restrictive agreements discussed above do not control for gift tax valuations. The event on which the option is conditioned has not yet occurred. The donee has the right to continue to hold the shares, receive dividends and exercise the rights of the shareholder and in making a gift, can select the timing of the transfer. However, the agreement is a factor to consider in valuing a gift.[xxxix]

Chapter 14 Valuation Rules

The 1990 Revenue Reconciliation Act added IRC Sections 2703 and 2704 to provide that certain restrictive agreements will not be considered in valuing corporate or partnership interests for estate and gift tax purposes.

IRC Section 2703 generally is directed to the use of buy-sell agreements while IRC Section 2704 governs other types of restrictions placed on stock effective for agreements entered into or substantially modified after October 8, 1990.

In addition, IRC Section 2703 provides that, for purposes of the estate, gift and generation skipping taxes, buy-sell agreements and other restrictions on property are disregarded for valuation purposes unless they are:

1. Bona fide business arrangements,
2. Not intended to transfer property to a family member for less than full consideration, and
3. Comparable to similar arrangements regardless of the identities of the parties.

Summary

You have learned in this lesson that the terms of a restrictive or buy-sell agreement should be analyzed to determine its effect on the value of the stock. One of the most important actions you can take when you receive this type of case is to read the agreement. It should be in the case file.

In addition, facts relating to the business purpose, testamentary purpose and reasonableness of the purchase should be developed.

The next lesson discusses investment company valuations and the effect of letter stock and Securities and Exchange Commission (SEC) Rule 144 on the valuation of the stock.

Answers to Exercises

Exercise 1

At his death, Jack Travis owned 30 percent of the stock of the Hayes Corporation. Five years before Travis' death, Travis and the other shareholders of Hayes entered into an agreement which provided in part:

1. If the shareholders of Hayes wish to sell their shares, they will offer the shares first to al the other shareholders for a period of 30 days. If the other shareholders do not buy the stock, it will be offered to the corporation for 30 days. If the corporation does not buy the stock, it may be offered to any third party for a period of six months.

2. At the death of a shareholder, the estate shall offer to sell the stock in the manner described above.

Upon the death of Travis, the estate sold his stock to the corporation for the price provided for in the agreement.

The corporation has always purchased the stock if it is ever offered for sale. Does the agreement price fix the value in the estate?

Answer

This agreement represents a right of first refusal agreement. It does **not** fix the value in an estate. It is a factor to consider.

Exercise 2

The agreement for the sale of Hayes stock discussed in Exercise 1, further provides:

3. The purpose of this agreement is to provide continuity of management.

The stockholder of Hayes are:

- Jack Travis and his wife
- Tom and Andrew Travis, Jack's brothers and their wives
- Jack's two sons
- Tom's three sons
- Andrew's daughter
- Three unrelated employees

a. Does this agreement have a bona fide business purpose or is it a testamentary device?

Answer

The stated purpose of the agreement qualifies as a bona fide business purpose. The large number of shareholders, many of whom are not related or have a close relationship would indicate no testamentary device.

b. Is there a stronger argument for a testamentary device if the shareholders were just Jack and his two sons?

Answer

Yes, fewer shareholders with a close lineal relationship.

Exercise 3

The Hayes agreement provides that the agreement price will be equal to adjusted book value.

a. Is this a reasonable price?

Answer

This is probably a reasonable price. However, it also depends on factors such as:

1. How is adjusted book value defined?

2. Whether adjusted book value is equal to FMV?

b. What other facts do you need?

Answer

Since, in this case, the agreement is merely a factor, an analysis of the value as discussed in lessons 8 and 9 is also needed.

Lesson 11

Restricted Securities and Investment Company Valuations

Contents

Introduction

In this lesson you'll learn about restricted stock. We define terms like "letter stock" and "control stock" and describe the operation of Securities and Exchange Commission (SEC) Rule 144, which sets forth the procedures and limitations for marketing stock which it governs. We also cover investment companies. You'll learn to evaluate the factors to be considered in valuing investment companies and real estate companies.

Objectives

At the end of this lesson, you will be able to:

1. Define letter stock and explain the operation of SEC Rule 144 and

2. Identify the factors considered in valuing a closely held investment company.

Letter Stock

Generally, securities sold in interstate commerce must be registered with the SEC prior to sale. We know what the value of this type of stock is on the open market. Stock that is not registered with the SEC can be held for investment, but only resold in extremely limited situations. The most important exception to this resale limitation is SEC Rule 144.

It is important to understand at this point that the restrictions and limitations discussed here are based on the operation of law. This is very different from the contractual restrictions that we studied in Lesson 10, which were of the taxpayer's making. There will be no debate on whether the SEC restriction was for a tax benefit since the taxpayer has no control over these rules.

Definition of Letter Stock

Extract

Rev. Rul. 77-287[xl]

* * * * *

> The terms "investment letter stock" and "letter stock" denote shares of stock that have been issued by a corporation without the benefit of filing a registration statement with the SEC. Such stock is subject to resale and transfer restrictions set forth in a letter agreement requested by the issuer and signed by the buyer of the stock when the stock is delivered. Such stock may be found in the hands of either individual investors or institutional investors.

* * * * *

The full text of Rev. Rul. 77-287, which was also discussed in Lesson 7, is repeated at the end of this lesson as **Exhibit 11-1** [not included in this posting].

"Letter stock" is also called "investment letter stock," "private placement stock," "legend stock" or "unregistered stock."

The buyer of the stock gives a letter to the issuing corporation, which sets forth the terms and conditions of ownership. The stock certificates may also be stamped with a statement that they are unregistered. You should request a copy of this letter and a copy of the stock certificate, because these documents provide information, such as the date of restriction, which is relevant to valuation.

You should also note that it is possible to have letter stock without a letter or stamp, but the history of ownership would indicate that it is letter stock.

Taxpayers often claim substantial discounts on letter stock because of the restrictions on marketability. Even if the stock to be valued is letter stock, the stock can be sold without restriction, if it meets the SEC Rule 144 requirements. Obviously, the value of the stock would be higher if it could be sold under SEC Rule 144.

Requirements of SEC Rule 144

SEC Rule 144 (**Exhibit 11-2** [not included in this posting]) allows holders of restricted or control securities to sell those shares on the open market provided certain specified conditions are met by the issuer, the seller, and the broker. SEC Rule 144 was adopted by the Securities and Exchange Commission in 1972 to eliminate the uncertainty that existed under previous rules and regulations covering the sale of restricted and control securities.

The rule specifies certain requirements such as:

1. availability of current public information about the issuers,

2. holding periods for restricted securities before sales,

3. limitations on the amount of securities that may be sold,

4. restrictions on seller's and broker's activities,

5. notification of sales to the SEC.

Definitions

Restricted Securities

Restricted securities (stock) are securities acquired in a transaction not involving a public offering.

Some examples of restricted stock are:

1. stock acquired in a private placement,

2. stock acquired from someone who directly or indirectly controls the management of the issuer,

3. securities acquired through employee stock options,

4. securities obtained through employee stock purchase plans without registration,

5. securities distributed to employees as a bonus or under a pension or profit-sharing plan.

Control Securities

Control securities are defined as securities owned by any person who directly or indirectly controls the management and activities of the issuing company; usually senior officers, directors and certain large shareholders.

Restricted and control securities have different holding periods and volume limitation requirements.

Rule 144 — Current Public Information Requirement

This rule permits the sale of restricted or control securities, only if current information about the company is readily available to the public and the financial community.

1. The issuing company must be a "reporting company" at least 90 days before the proposed sale date.

2. The issuer must have filed all of the reports required by the SEC during the 12 months preceding the sale.

3. Securities issued by nonreporting companies may also be sold under SEC Rule 144 if certain specified information is available.

All participants in a SEC Rule 144 sale are required to be certain that all public information disclosures have been satisfied. The seller may rely on issuer's most recent annual or quarterly report or a written statement from the issuer, unless the seller knows or has reason to know that the issuer has not complied with the reporting requirements.

Holding Period Requirements

Restricted Securities

Under SEC Rule 144 the seller must have been the "beneficial owner" of restricted securities for at least two years. If the securities were purchased, they cannot be sold until two years after full payment has been made.

Control Securities

There is no required holding period for control securities that are not also restricted securities. For example, if a control person buys stock on the open market or exercises a stock option to buy stock for which a registration statement has been issued, there is no required holding period.

Securities Received as a Gift

If you acquire **control** stock as a gift from a control person, there is no required holding period before you can sell these securities, assuming that they were not "restricted securities" when held by the control person. However, for two years from the date you received the stock as a gift, your sales must be aggregated with sales made by the donor and the aggregate must stay within the volume limitations described below.

If you acquire **restricted** securities as a gift, the two year holding period before the securities can be sold can usually be assumed to begin on the date the donor acquired the shares. When the holding period is up, you can make sales, but any sale you make for two years after you received the shares must be aggregated with sales made by the donor.

Limitation on Amount Sold

SEC Rule 144 also restricts the amount of securities that may be sold curing any three-month period. In calculating transactions in order to keep within the limits described below, you must include, in addition to securities sold during the three-month period, those sold by any of the following:

1. relatives who live in the same house with you,

2. any trust or estate in which you or such relatives collectively own 10 percent or more of the beneficial interest, or serve as trustee, or executor, or in a similar capacity, or

3. any corporation or organization other than the issuer of the securities in which you or such relatives collectively own 10 percent or more of any class of equity securities or 10 percent or more of the equity interest.

Also, it is necessary to aggregate all sales in the three-month period made by persons in a close or proximate business or personal relationship with the seller.

If the securities are traded on a national stock exchange, the amount that may be sold in any three-month period is the **greater** of:

1. one percent of the shares outstanding as shown by the most recent report or statement published by the issuer; or

2. the average weekly reported composite trading volume in such securities during the four calendar weeks preceding the filing of Form 144, as required by the SEC.

If the securities are traded over-the-counter (OTC) and the National Association of Securities Dealers' Automated Quotation (NASDAQ) volume figures are available, you may sell in any three-month period the **greater** of:

1. one percent of the shares outstanding; or

1. the average weekly reported trading volume during the preceding four calendar weeks.

If the securities are traded OTC and no volume figures are available, you may sell one percent of the shares outstanding in any three-month period.

Method of Sale — Disposal of the Stock

SEC Rule 144 stock may be sold through a broker in a "brokers' transaction." A broker, acting as a market maker, can make no more than usual and customary broker's commission. The broker may not solicit buyers for the shares but may make inquiries of brokers or dealers. Finally, the broker is required to conduct a reasonable inquiry to assure compliance with SEC Rule 144.

Notice of Proposed Sale (Form 144)

If more than 500 shares are to be sold or if the aggregate sales price exceeds $10,000 during any three-month period, the seller must file three copies of a *Notice of Proposed Sale of Securities*, Form 144 (which is reproduced as **Exhibit 11-3** at the end of this lesson [not included in this posting]) with the SEC and, for listed companies, the seller also must file one copy with the principal exchange on which the securities are traded.

Exceptions to SEC Rule 144

1. Non-affiliates can sell restricted securities provided the securities have been fully paid for and the seller has beneficially owned the securities for at least 3 years. It is not necessary to file a notice of proposed sale (Form 144) with the SEC.

2. SEC Rule 144 eliminates the volume limitation with respect to a non-affiliate donee under certain circumstances

3. A former affiliate may sell restricted securities that have been held for three years without regard to the volume limitation when three months have elapsed since termination of the affiliate status.

Valuation of Closely Held Investment Companies

Another type of valuation which needs special mention is the valuation of closely held investment companies (CHICs). CHICs are corporations that do not own any operating assets. Instead, they own nonoperating assets such as corporate securities, Governmental obligations and real estate. For valuation purposes, emphasis is on these companies' adjusted book value, also called net asset value.

Extract

Rev. Rul. 59-60
Section 5

* * * * *

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such a earnings and dividend paying capacity.

* * * * *

Factors and Approach to Valuation of Investment and Real Estate Companies

The financial statements of most CHICs list their assets at cost. to calculate the CHICs value, it is necessary to determine the fair market value of all of its underlying assets. If publicly traded securities are owned, it is simple enough to determine their value, which is their trading price as of the valuation date.[xli] If the CHIC owns either real estate or the stock of other CHICs, you will have to value these items separately. The resulting fair market value of all the underlying assets, less actual liabilities, is the best indication of the total value of the CHIC.

Sometimes the financial statements may contain estimated or hypothetical liabilities for such things as estimated liquidation expenses which would be incurred upon a liquidation. The courts have consistently disallowed such hypothetical expenses.[xlii]

Example 1

The appraiser valued the Dooley Investment Company as follows:

Dooley Investment Company Valuation		
	Cost	**Fair Market Value**
Assets		
Traded Stock	$25,000	$255,000
Cash	20,000	20,000
Land	5,000	40,000
TOTAL ASSETS	$50,000	$315,000
Liabilities		
Brokerage acct.	$11,000	11,000
Mortgage	4,000	4,000
Estimated liquidation expense	15,000	---
TOTAL LIABILITIES	$30,000	$15,000
Book Value	$20,000	
Adjusted Book Value (FMV)		$300,000
Per share — 100 shares		$ 3,000
Net Asset Value of 10 shares		$30,000

There is a significant difference between book value and FMV.

When valuing a fractional interest in a CHIC, the question often arises as to whether each individual share is worth its proportionate part of the whole. In the above example, Dooley Investment Company, Inc. had 100 shares issued and outstanding, and the appraiser computed a tentative value for 10 shares. Is this interest worth $30,000? In many recent cases,[xliii] the Courts have accepted evidence showing that shares in publicly traded investment companies often sell for less than their proportionate share of the company's total value.

The evidence that is generally considered by the Court is the price-to-net-asset value of publicly traded closed-end investment companies. A closed-end investment company has a set number of shares issued and outstanding. Thus, on any given day the net asset value of its portfolio and the trading value of its shares can be determined. For example, assume that five closed-end investment companies with portfolios comparable to Dooley had price-to-net-asset ratios of 88 percent to 90 percent. An indication of the value of 10 shares of Dooley may be calculated as follows:

Example 2

10 Shares Dooley Investment Co. Inc.	
Net Asset Value of 10 shares	$30,000
Price to Asset Ratio of Comparables	90%
Adjusted Value	$27,000

The argument is sometimes made, that a price-to-net-asset valuation approach should be used to value a majority interest in a CHIC. The problem with this argument is that it seeks to equate majority and minority interests. The daily traded prices of closed-end investment companies are for minority interests. As such, the traded prices reflect market considerations, such as lack of control. It would be an error to merely assume, without adequate evidence, that a controlling interest would sell for less than net asset value.

Above, we calculated the price that 10 shares of Dooley would sell for, if publicly traded. Since it is not publicly traded, some courts have allowed a second discount for lack of marketability. A possible way to calculate this reduced value would be:

Example 3

10 Shares Dooley Investment Co. Inc.	
Sales price if publicly traded (from Example 2)	$27,000
Cost of secondary offering (assume at 20% of above)	5,400
Fair Market Value	$21,600

Some courts have simply applied a flat discount. This could result in discounting the same value twice.

Example 4

10 Shares Dooley Investment Co. Inc.	
Net asset value of 10 shares of ABC (from Example 1)	$30,000
Price/asset ratio and lack of marketability (10% from Example 2; 20% from Example 3)	9,000
Fair Market Value	$21,000

Example 3, rather than Example 4, duplicates the actual market process. This is because an underwriter calculates the commission on the basis of the projected public offering price.

Summary

Restricted and control securities come within the purview of SEC Rule 144. We have attempted to set forth a working approach to the operation of the Rule. The detailed regulations, for the most part, in question and answer form, are included to provide greater insight when difficult questions arise.

To properly determine fair market value of an investment company, it is necessary to consult with published services such as *ValueLine*. Using this type of service, you are able to better determine the prevailing discount in the market for an investment company or a real estate company, or a trust in which most of the underlying assets are real estate, if it is established that some discount is appropriate in these instances.

Lesson 12

Valuation of Preferred Stock

Contents

Introduction

Although the great majority of corporate stock valuations coming before an appeals officer involve common stock, an issue may occasionally arise regarding valuation of preferred stock. This might happen, for example, when preferred stock is gifted to a charity. Another common example is the "estate freeze," where a shareholder exchanges his common stock for a new issue of preferred, in order to transfer potential appreciation of his stock interest to younger family members. This is normally done in a tax-free recapitalization within the meaning of IRC § 368(a)(1)(E). The following example illustrates this estate planning technique.

Example 1

Bryte owns 100 percent of Aces Corp. which has a fair market value of $1,500,000. In a recapitalization, Bryte receives preferred stock with a par value of $1,400,000 and new common stock which Bryte then gifts to his children. Bryte asserts that the value of the gifted common stock is $100,000 which is the difference between the total value of the corporation and the par value of the retained preferred stock ($1,500,000 - 1,400,000). Any future growth of the company would be allocable to the common stock owned by the children, and upon Bryte's death, the estate will value the preferred stock at no more than par value and perhaps less to reflect a discount for lack of marketability.

The tax effectiveness of the transaction described in the above example depends on Bryte's ability to establish that at the date of issue of the new stock, the fair market value of the preferred stock was $1,400,000 and, conversely, that the gifted common stock had a value of only $100,000. Any disparity in valuation will make this transaction a transfer for insufficient consideration, and thus a taxable gift under IRC § 2512(b).

Objectives

At the end of this lesson, you will be able to:

1. Identify the characteristics of preferred stock.
2. List the key factors to be considered when valuing preferred stock.
3. Recognize the gift and income tax issues resulting from a recapitalization where the preferred stock is undervalued.

Characteristics of Preferred Stock

As with any security, the valuation process starts by analyzing the characteristics, rights, and restrictions established upon issuance of the shares. A preferred shareholder is normally given a variety of rights, which might include any of the following:

1. A fixed dividend with a priority over any payment of cash dividends to common stock. This dividend might be "cumulative" or "noncumulative" depending on whether the issuer can skip dividend payments, with no shareholder claim to the lost dividend,
2. A fixed claim upon liquidation of the company, with priority over any distribution of proceeds to the common stock,
3. Full, partial, or no voting rights,
4. Participation in corporate profits to some extent, or no participation,

5. Conversion capability into common shares, or no conversion rights,

6. "Redemption" rights at the option of the shareholder; "call" rights at the company's option,

7. Contingent rights (for example, "put" options, voting power or board representation) in the event one or more dividends are omitted, or

8. Seniority over or subordination to the rights of other preferred issues.

The normal public issue is a nonvoting, nonconvertible, nonparticipating, cumulative preferred stock with certain contingent rights if payments are skipped. These issues may generally be directly compared with publicly traded preferred stocks on which published market prices and current dividend yields are available.

For some privately held companies, however, "nonstandard" preferred stock is the norm. In a recapitalization, for example, the dividend payment is often made noncumulative in order to let the company avoid obligatory cash payments and preserve cash for growth. Other "bells and whistles" may also be added to the preferred stock in an attempt to recoup some of the value lost by making the dividend noncumulative. This can create serious valuation problems, since almost no noncumulative preferred stock has been offered in the public market since the 1950s.

Rev. Rul 83-120 — Approach to Valuing Preferred Stock

Rev. Rul. 83-120,[xliv] included here as **Exhibit 12-1** [not included in this posting], amplifies Rev. Rul 59-60 by specifying additional factors to be considered in valuing the preferred stock of a closely held corporation. [**Note**: This revenue ruling is really a revenue procedure, as it lays out in a step-by-step manner, how to approach this type of valuation.] According to the ruling, the three principal measures in valuing preferred stock are:

1. **Income coverage —** Measures protection for the preferred dividend claim. Inadequate coverage exists where a decline in company profits would jeopardize the company's ability to pay dividends. This coverage is computed by dividing the sum of pre-tax net income plus interest expense by the sum of the interest expense after-tax dividend requirements.

2. **Asset coverage —** Measures protection for the preferred liquidation claim relative to market value of the company's net assets (total assets minus total liabilities). This coverage is computed by dividing the market value of the company's net assets by the aggregate liquidation preference of the preferred stock.

3. **Yield —** Measures return on investment. This is computed by dividing the stated annual dividend rate by the cost or par value of the preferred stock.

Once the above ratios are developed, they can be compared with the ratios of publicly held preferred stocks. Information on the latter can be obtained from many sources (See **Exhibit 7-5** [not included in this posting]). Adjustment must be made for important differences in the preferred stock being valued. These techniques can be best illustrated by a hypothetical case study.

Case Study

On October 1, 1990, 100 shares of common stock of Farmacre are issued and outstanding. Mr. Farmer, his wife and two sons each own 25 shares of common stock.

The price of farm land has increased dramatically over the last five years (1986 to 1990). Therefore, Mr. Farmer's attorney, Mr. Freeze, recommends some estate planning to lower potential death taxes. Mr. Farmer and his wife agree to exchange their 50 shares of common stock for 20,000 new shares of 10 percent preferred stock with a par value of $100 per share. The idea is to transfer the potential appreciation in the common shares to the two sons.

At the end of the transfer, high grade publicly traded preferred stock was yielding 14 percent. Mr. Freeze was aware, however, that the Company's earnings were not sufficient to support a 14 percent dividend. Even at the 10 percent dividend rate, the yearly preferred dividend requirements would equal $200,000 per year. The corporate earnings are summarized in the following table.

Corporate Earnings

Year	**Pre-Tax and Pre-Interest Earnings***
1986	$198,000
1987	155,000
1988	175,000
1989	170,000
1990	125,000

***** The corporation has no outstanding debt and no interest expense. Corporations with high grade preferred stock have earnings about 2.5 times the needed preferred coverage.

To prevent an embarrassing shortage, Mr. Freeze made the new issue of preferred stock noncumulative. To make up for this shortcoming, he added a full liquidation preference to the preferred stock, since he was aware that the company's farmland had doubled in value between 1986 and 1990. He also added a provision that the stock would be redeemable at par value at the death of the shareholder.

The preferred stock possessed no voting rights. Any dividend would, therefore, be made on the sole authority of the common shareholders. Since the sons were concerned that they might be open to suit if a preferred dividend were skipped, they requested (and received) a provision to bar suit for nonpayment of dividends.

An analysis of the above facts under Rev. Rul. 83-120 might be as follows:

Dividend Yield

Extract

Rev. Rul. 83-120

*   *   *   *   *

.02 Whether the yield of the preferred stock supports a valuation of the stock at par value depends in part on the adequacy of the dividend rate. The adequacy of the dividend rate should be determined by comparing its dividend rate with the dividend rate of high-grade publicly traded preferred stock.

*   *   *   *   *

According to the ruling, since the present stock has a dividend rate of 10% lower than the 14% rate for high-graded, publicly traded preferred stock, a value of "less than par" is indicated.

Dividend Rate

Extract

Rev. Rul. 83-120

*   *   *   *   *

.03 The actual dividend rate on a preferred stock can be assumed to be its stated rate if the issuing corporation will be able to pay its stated dividends in a timely manner and will, in fact, pay such dividends. The risk that the corporation may be unable to timely pay the stated dividends on the preferred stock can be measured by the coverage of such stated dividends by the corporation's earnings… Moreover, the absence of a provision that preferred dividends are cumulative raises substantial questions concerning whether the stated dividend rate will, in fact, be paid.

*   *   *   *   *

In the present case, the risk that the corporation might not be able to meet dividend requirements is much greater than for the publicly traded preferred stock. Making the stock noncumulative may reduce the coverage problem, but the depressing effect on fair market value is probably greater than inadequate coverage.

Voting Rights

Extract

Rev. Rul. 83-120

.05 Another factor to be considered in valuing the preferred stock is whether it has voting rights and, if so, whether the preferred stock has voting control.

* * * * *

The preferred stock in the present case has no voting rights, which is the norm.

Peculiar Covenants

Extract

Rev. Rul. 83-120

* * * * *

.06 Peculiar covenants or provisions of the preferred stock of a type not ordinarily found in publicly traded preferred stock should be carefully evaluated to determine the effects of such covenants on the value of the preferred stock. In general, if covenants would inhibit the marketability of the stock or the power of the holder to enforce dividend or liquidation rights, such provisions will reduce the value of the preferred stock by comparison to the value of preferred stock not containing such covenants or provisions

* * * * *

The “covenant not to sue” in the present case has a depressing tendency on the value of the preferred, since it makes it even more likely that dividends will be skipped.

Redemption Privileges

Extract

Rev. Rul. 83-120

* * * * *

.07 Whether the preferred stock contains a redemption privilege is another factor to be considered in determining the value of the preferred stock. The value of a redemption privilege triggered by death of the preferred shareholder will not exceed the present value of the redemption premium payable at the preferred shareholder’s death (i.e., the present value of the excess of the redemption price over the fair market value of the preferred stock upon its issuance). The value of the redemption privilege should be reduced to reflect any risk that the corporation may not possess sufficient assets to redeem its preferred stock at the stated redemption price.

* * * * *

Note that, under IRC § 305, income may be realized and recognized if the redemption value of the stock exceeds the FMV of the stock at issuance by more than ten percent. The difference (i.e., "premium"), could be recognized as ordinary income, included ratably over the remaining expected life of the stockholder. See Treas. Reg. § 1.305-5(b) for a more complete discussion.

The "asset coverage" in the present case is more than adequate, and therefore the redemption privilege is a valuable "bell and whistle." Income tax problems must be carefully considered as noted above.

Questions for Discussion

1. What arguments would you make that Mr. and Mrs. Farmer have made a gift to their children, the common shareholders?

   Answer

2. What adjustments could be made to the rights of the preferred stockholders to decrease the amount of the gift?

   Answer

3. Could the gift ever be totally eliminated without the use of cash "boot"? Why or why not?

   Answer

Allocation of Value Between Preferred and Common Stock

The Service's position, set out in Rev. Rul. 83-120, is called the "subtraction method." This approach requires that the value of the preferred shares be subtracted from the overall value of the company in order to determine the value of the stock. This is the usual method for valuing preferred stock in a company which has a complex capital structure including preferred and common stock.

In the recent, very unique estate tax case, Newhouse Estate v. Commissioner,[xlv] limits were set on the allocation of a corporation's value between different classes of stock. The Tax Court rejected the subtraction method in Newhouse. According to the Court, the assumption that the sum of the fair market values of the preferred stock and the common stock, each sold independently to separate buyers, must equal the net value of the entire company as a going concern, is flawed and "simplistic." The Court held that a proper allocation may depend on the corporation's overall capital structure, relevant state law issues, and the size of the corporation. Since these factors are all judgmental and rather nebulous and unique to the case, principally due to the company's capital structure, which was so unique it would be unlikely to find such a capital structure in another company. As such, the Service's position continues to be that the "subtraction method" is the appropriate method to use in allocating the value of a corporation between common and preferred stock.

New Chapter 14

New Chapter 14 (IRC §§ 2701, 2703, and 2704) is intended to modify the gift tax (but not estate tax) valuation rules to more accurately value the initial transfer. For purposes of determining whether a gift has been made and in what amount, the value of the transferred property is the fair market value of the entire interest of the transferor in the property prior to the transfer, less the value (determined under Chapter 14) of the interest in the property retained by the transferor. The new rules apply generally to transfers after October 8, 1990.

Summary

This lesson was intended to give you some familiarity with the unique characteristics of preferred stock. Because it has many of the features of debt instruments, yet maintains the elements of equity instruments, it has been a popular component of the capital structure of many closely held corporations. New Chapter 14 of the Code attempts to deal with some of the abuses involved in the use of preferred stock, and may well diminish its popularity.

Lesson 13

Valuing Intangible Assets

Contents

Introduction

In this lesson, we will identify some of the more common intangible assets and discuss the treatment of these assets before and after the enactment of § 197.

Historically, the valuation of intangible assets in the context of asset and stock purchases resulted in numerous income tax disputes. Goodwill/going concern value had always been a nonamortizable intangible asset because its useful life could not be reasonably determined.

In the 1980s, taxpayers became more aggressive in valuing and lifing intangible assets, many of which were considered part of goodwill/going concern. The Service's position was that, as a matter of law, many of these assets were not separable from goodwill/going concern value and, therefore, were not amortizable.

In 1993, the Supreme Court, in Newark Morning Ledger,[xlvi] ruled that an intangible asset can be amortized if it can be valued and its useful life can be reasonably determined.

In 1993 Congress enacted § 197 which provides for the amortization of most acquired intangible assets, including goodwill and going concern value. The amortization period is 15 years irrespective of the asset's economic or legal life. The methods used to determine the fair market value of intangible assets before and after the enactment of § 197 are the same.

Objectives

At the end of this less, you will be able to:

1. Identify various intangible assets.

2. Identify and describe various methods used to value intangible assets.

Brief Look at § 197

Section 197 is effective for transactions in which intangible assets were acquired after August 10, 1993. A taxpayer may elect to apply this section to acquisitions made after July 25, 1991, or may elect out of this section if a binding contract was in effect on or before August 10, 1993. Some of the intangible assets that qualify for amortization under this section include, but are not limited to:

- Goodwill,
  - Going concern value,
- Workforce in place,
  - Customer based intangible assets,
  - Supplier based intangible assets,
  - Rights granted by any governmental unit,
  - Franchises, trademarks, and tradenames, and
  - Covenant not to compete.

Some of the intangible assets excluded from amortization under this section are:

- Off-the-shelf computer software,
  - Tangible property leases,
  - Interests in indebtedness,
  - Financial interests,
  - Interest in land, and
  - Professional sports franchises.

Estimated Useful Life

Although the useful life of most intangible assets has been established for amortization purposes by § 197, the economic useful life must be determined in order to value these assets where an income appropriate to value is used (most cases). In order to determine the economic useful life the following statistical approaches are commonly used.

Survivor Curve Lifing

The theory of the survivor curves (Iowa Curves) was developed at Iowa State University in the early 1900s. Survivor curves are used to predict the mortality or decay of a group of similar data points as the data points age. Survivor curve theory is similar to the mortality theory used by actuaries to estimate human life spans.

A lifing study is the process of predicting the behavior of a group of data points by fitting a "test group" to various survivor curves. Thus, by selecting the survivor curve that best describes the decay of the test group in the past, the future behavior of each data point in the group can be estimated. This approach was used by the taxpayer in Citizens and Southern Corp.[xlvii] The use of appropriate survivor curves determined from intangible relationships may be applicable.

"Iowa Curves" used to analyze the lives of tangible assets are likely wholly inappropriate to determine the estimated lives of intangible assets.

Attrition Rate Method

In order to determine the useful life using the attrition rate method, the number of deletions or terminated accounts occurring during a period of time is divided by the total number of accounts active at the beginning of that period. The resulting attrition rate is then converted into an annual rate and finally into a corresponding estimated useful life.

For example, if there are 100 accounts active at the beginning of the year and during the year, 10 accounts are terminated, the resulting rate of attrition experienced during the year is equal to 10 divided by 100 or 10 percent. Customer location contracts were lifed in this manner in Business Service Industries, Inc.[xlviii]

Turnover Study Method

This method considers the annual additions and retirements of the particular assets. The age of the retirements is not known, only the year in which they occurred. When data are available for a long period and when the asset is stable, this method produces acceptable results. It is not a reliable method for new and growing properties or for changing conditions.[xlix]

In the text, *Mortality Table Construction* (Prentice Hall, 1978), the author, Robert W. Bratten, lists a number of factors which would introduce errors or distortions in mortality rates. While Bratten is concerned primarily with life insurance policies, the factors are applicable to most statistical studies.

The following items should be considered when evaluating useful life studies:

- Reasonableness of results,
  - Sufficiency of data,
  - Homogeneity of input data,
  - Stability of conditions,
  - Maturity of input data,
  - Unit of investigation,
  - Standard use for comparison purposes,
  - Length of observation period, and statistical distortions.

Valuation Methods

Once the economic life of the assets is determined, the valuation of the assets can be completed. Listed below are five methods that can be used to value intangible assets:

1. Bargain of the parties
2. Income approach
3. Cost approach

4. Market approach

5. Residual gap approach.

Bargain of the Parties

The basis for using the bargain of the parties method is that the buyer and seller agreed to allocate a portion of the purchase price to intangible assets. The Service and the courts generally do not upset a contract method of allocation, if the buyer and seller had adverse tax consequences, the allocation was at arms length, and the allocation had economic substance. The courts have rejected this method when it has been determined that the allocations are not reflective of the true transaction.

Income Approach

The income approach is defined as the "present value of future net cash flows." This approach is commonly used for intangible assets with in income stream (for example, patents, royalty interests, bank core deposits, customer lists, favorable contracts, etc.).

The approach, as it relates to intangibles, can take many forms:

- Royalty savings from not having to pay a royalty to exploit technology represented by the intangible asset.
    - Enhanced cash flow attributable to the intangible asset.
    - Loss of income approach. (Typically used to value covenants not to compete).

The income approach can result in double counting of other income producing assets. All of the elements of a business operate to produce the income received. To attribute the entire income stream to one specific intangible asset in the discounted cash flow computation, greatly overstates the value of that intangible. If the same methodology is also used to value other intangible assets, the combined projected income stream for all assets may exceed the total forecasted income for the business.

Part of the income should also be attributed to the other elements of the business such as tangible assets and other intangible assets. A reasonable rate of return should be computed for each asset and the income stream attributable to these other assets should be deducted from the total income stream in order to isolate the income attributable to each separate intangible asset.

Net after-tax cash flow may include a "tax shield." The tax savings to be realized from the ownership of an amortizable asset is an item of cash flow which is properly included in the value of the asset. The tax shield is the present value of the tax savings attributable to the amortization deductions.

Where cash flow streams are proven and quantifiable, a value may be easily derived. However, certain assumptions are subject to challenge such as the discount rate, the inflation rate and obsolescence factors. Further, useful life determinations may be subject to challenge.

Cost Approach

The cost approach involves the estimation of the cost to reproduce or replace the intangible asset in like kind utility as of the valuation date. There are two applications of this approach as listed below.

Replacement Cost (Market Alternative)

Replacement cost refers to the costs incurred to replace the intangible asset at prices in existence as of the valuation date less obsolescence.

This method presumes an established market for the asset to be valued, e.g., off-the-shelf software.

Reproduction Cost (Avoided Cost)

This refers to the cost to reproduce/recreate the asset using costs (e.g., labor, advertising, etc.) in existence on the valuation date.

The maximum limitation on reproduction cost value is replacement cost.

This method is typically used to value special purpose assets or assets in which value is somewhat speculative. For example, patent applications, unproven technology, customized computer software.

Under both the replacement and reproduction cost approaches, values must be adjusted for obsolescence (software or technology may be inferior due to new developments), contingencies, and other factors affecting value.

Market Approach

This approach involves the analysis of current market prices for similar assets in actual transactions, e.g., franchises, distributorships, etc. It involves the use of documented sales of comparables to establish value.

This approach is similar to the replacement cost approach.

This approach is more suited to valuing tangible assets rather than to intangible assets. Unique factors contribute to the value of many intangible assets and, therefore, there is often no comparable to consider.

Residual Gap Approach

This approach should be used to value goodwill/going concern value. After the purchase price has been allocated to tangible and intangible assets, the remainder of the purchase price, if any, is attributed to goodwill/going concern value.

Treas. Reg. § 1.338(b)-2T requires that under the residual method, all allocations of purchase price be made in the following manner:

1. **Class I Assets —** Cash, demand deposits, and similar items.

2. **Class II Assets —** Certificates of deposit, U.S. Government securities, readily marketable stock or securities, foreign currency, and other similar items.

3. **Class III Assets —** Assets not included in Classes I, II and IV. Includes all other transferred intangible and tangible assets (e.g., furniture, fixtures, land, accounts receivable, and covenants not to compete).

4. **Class IV Assets —** Intangible assets in the nature of goodwill and going concern value.

Once all Class I, Class II and Class III assets of a business have been valued the remainder of the purchase price (in the case of estate tax the estimated value) represents goodwill/going concern value.

Note: These regulations are likely to be revised to reflect changes in §§ 338 and 1060 of OBRA 1993.

Example 1

Roger Company was sold in 1995 for $1,000,000. The computation of goodwill/going concern is made as follows:

Goodwill/Going Concern Computation	
Purchase Price	$1,000,000
Less fair market value of all Class I, II, and III assets	600,000
Value of goodwill/going concern	$400,000

The most frequent income tax controversy in the area of the valuation of goodwill/going concern involves the question of allocation of the purchase price of a business between the various classes of tangible and intangible assets. Usually, the taxpayer assigns the bulk of the purchase price to depreciable assets with the minimum allocated, where necessary, to nondepreciable assets. It is necessary, in these cases, to determine the fair market value of the depreciable assets of the business so that the values reported can be either adjusted or verified.

Specific Intangible Assets

Starting in the early 1980s and lasting about a decade, an unprecedented number of mergers and acquisitions occurred. Taxpayers did not look favorably upon the prospect of allocating any part of purchase price to non-depreciable/non-amortizable assets such as goodwill and going concern value. Accordingly, taxpayers became more aggressive in allocating large portions of the purchase price to various reportedly amortizable intangible assets such as core deposits, customer lists, assembled work force, etc.

At the time of the decision in Newark Morning Ledger, there was a substantial inventory of unresolved cases involving many intangible asset issues. The National Office established an intangible asset settlement task force to develop a Servicewide settlement of all the intangible asset issues rather than dealing with the numerous intangible assets on an asset-by-asset basis. The Intangible Settlement Initiative applies to all acquisitions made prior to July 25, 1991 and in an open examination as of April 1, 1994. Additional information on this settlement is available in Document 9233, Intangible Settlement Information.

Even though § 197 provides for the amortization of many intangibles including goodwill/going concern value, the valuation of intangible assets is still an important consideration.

Section 197(f)(1) does not allow for a loss to be recognized by reason of a disposition of a § 197 intangible if the taxpayer retains one or more other 197 intangibles which were acquired in the same transaction. However, a gain is recognized on a disposition of this sort. This means there is an incentive for taxpayers who anticipate selling certain intangibles at a gain after acquisition to value them at a higher value so less gain is reportable. Or, if a taxpayer anticipates selling certain intangibles at a loss, a lower value might be assigned on acquisition to minimize a loss which can't be recognized.

Assembled Workforce

An assembled workforce is the value inherent in having a trained staff of employees in place; the benefit derived from not having to hire and train a new workforce. The assembled workforce refers only to non-contract employees. An assembled workforce issue has been decided in Ithaca Industries.[1]

The only appropriate method of valuing an assembled workforce is the **avoided cost method.** This method identifies avoided costs of hiring and training a like sized and skilled workforce. The workforce must be valued as a whole, not as individual employment relationships.

Customer Based Intangible Assets

A customer based intangible asset is an asset the value of which is determined with reference to the expectation of continued customer patronage.

Customer lists, subscriber lists, advertiser lists and insurance expirations are some examples of customer based intangible assets.

The valuation must be based on data available as of the acquisition date.

In dealing with customer based intangible assets, the taxpayer has a significant burden to prove that the intangible asset has a limited useful life and that its duration can be ascertained with reasonable accuracy. In Newark Morning Ledger, the Court agreed that the taxpayer's burden of proof was significant.

Core Deposits

Core deposits are deposits held by a banking institution which constitute a relatively low cost source of funds, are reasonably stable over time, and are relatively insensitive to interest rate fluctuations. These include funds on deposit from:

1. interest-free checking accounts,

2. interest-paying checking accounts, and

3. savings accounts, with or without a passbook.

They do not include:

1. certificates of deposit,

2. money market accounts,

3. government accounts, and

4. other accounts bearing interest rates which fluctuate in response to market conditions.

The spread between the costs incurred and the interest paid on the core deposits and the rate of interest that would be paid for comparable market based securities (e.g., C.D.s) represents a positive income stream to the banking institution. The present value of this income stream has been represented as an amortizable asset referred to as core deposits.

The value of core deposits is the present value of the cost savings to be realized.

Favorable Contracts

The Courts have held that a favorable contract is an amortizable asset. When a contract is transferred to a new owner, an advantage to the purchase occurs when the contract price is below market price.

The accepted method of valuing this type of asset is the present value of the cost savings (current market price less contract price).

Patents

Another amortizable intangible asset is a patent. A patent grants an exclusive right to manufacture, use and market an invention, process or discovery. The accepted method of patent valuation is to estimate the earnings that the owner could realize from royalties if the owner granted an exclusive unlimited license for the use of the patent for its remaining useful life. An example of this valuation follows.

Example 2

Widget Company was purchased by Tool Company. Widget held the patent, with a useful life of 15 years, on a product that Tool wants to manufacture. The patent was transferred to Tool as part of the purchase. Tool's appraiser valued the patent as follows:

Projected Annual Sales	$1,000,000
Royalty Rate	5%
Royalties	50,000
Present value factor (the right to receive $1 every year for 15 years at a 12% interest rate)	6.8109
	$ 340,545

In the above example, we have assumed that yearly sales will approximate $1,000,000 per year and that the customary royalty rate in the industry is 5 percent. Generally, a safe rate is determined and this amount is then increased for risk.

The issues that commonly arise in the valuation of patents are determining:

- whether a patent is "active" or "inactive," as of the valuation date;
- an accurate projection of the annual sales of the products covered by active patents;
- the appropriate "market" royalty rate to infer for the active patents;
- the remaining economic life of the patent, as compared to its remaining legal life; and
- the appropriate discount rate to use in discounting projected royalty earnings back to present value.

Covenants Not to Compete

The courts have applied three standards to covenants: the Danielson rule (strong proof or parol evidence), the "intent test," and the "economic reality" test. The economic reality test (which is recommended) requires consideration of the following factors:

- The age and health of the covenantor;
    - The covenantor's financial capability to compete;
- The extent to which the covenantor possessed the technical expertise and know-how necessary to engage in a competing business enterprise;
- The extent to which the covenantor possesses the machinery, equipment and/or tools which will enable him or her to pose a competitive threat;
- The covenantor's business contacts with employees of the purchased business or other professionals in the industry;
- The covenantor's ability to attract, or lack of interest in attracting, existing clients of the business;
- The covenantor's stated intention as to whether or not the covenantor is interested in competing;
    - The covenantor's legal capacity to compete;
    - The covenantor's business reputation with the industry or community;
    - Was the covenantor intending to maintain residence in the same geographic area?;
    - Was the covenant not to compete required by a third party?

All of these factors are considered in determining the allowability of a deduction for amortizing a covenant not to compete.

There are a number of methods used to value covenants not to compete; the two most common are either based upon the income given up by the covenantee or the loss to the covenantor for the covenanted period if the covenantee were to compete.

Franchises, Trademarks and Trade Names

Franchise — IRC § 1253(b)(1) defines a "franchise" as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, service, or facilities, within a specified area." The term "franchise" includes distributorships or similar exclusive-type contractual agreements pursuant to which the transferee is permitted or licensed to operate or conduct a trade or business within a specific area.

Amortization

If a taxpayer elects the application of IRC § 1253, then the amortization allowed is as follows:

- In the case of a transfer prior to October 3, 1989, the amortization period is the term of the agreement or 10 years whichever is less.

- In the case of a transfer after October 3, 1989 the amortization period is 25 years unless the franchise purchase is $100,000 or less then the amortization period is 10 years.

Generally, in the case of transfers after August 10, 1993, § 197 applies and the amortization period is 15 years.

Trademark — IRC § 1253 also applies to trademarks and trade names. A “trademark” is defined as “any name, symbol or device, or any combination thereof, adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others.”

Trade name — A “trade name” is defined as “any name used by a manufacturer or merchant to identify or designate a particular trade or business or the name or title lawfully adopted and used by a person or organization engaged n a trade or business.”

Trademarks/trade names are treated the same for valuation purposes. The accepted method of valuing trademarks/trade names is to estimate the earnings that the owner could realize if the owner granted an exclusive unlimited license for the use of the trademarks/trade names. The earnings are determined by taking an estimated royalty rate and multiplying it by the sales of the product or services covered by the trademark/trade name. This figure is then capitalized (see lesson on valuation of corporation for the procedure to determine the proper capitalization rate).

General Comments

Errors in Intangible Asset Allocations

There are several errors that occur frequently when valuing intangible assets. These errors include:

- reconciling valuation lives and useful lives;

  - making unreasonable, arbitrary and unsubstantiated income allocations; and

  - determining the source of cash flow — depreciation from the correct asset.

Reconciling Valuation Lives and Useful Lives

For many intangible assets, the useful life is the full period in which there is value or benefit derived from the asset. Frequently, the taxpayer values an asset by discounting an income stream of 15 years. However, in the depreciation computation, a useful life of seven years is used.

Example 3

A patent has generated royalties of $100,000 each year. The patent has a legal life of 10 years remaining. A reasonable discount for present value is determined to be 10 percent.

Present Value	**10 Year Life**
Annual Royalty	$100,000
Useful Life	10 years
Discount Rate	10%
PV of Patent	$614,457

When the taxpayer computes the depreciation deduction, the taxpayer uses a useful life of 5 years. As a result, the depreciation deduction is computed as:

Depreciation		**5 Year Life**		
Patent Value	=	$614,457	=	$122,891
Useful Life		5 years		

Based on the original life determined to be ten years, the depreciation deduction should be computed as:

Depreciation		**10 Year Life**		
Patent Value	=	$614,457	=	$61,446
Useful Life		10 years		

If the five year life is correct:

Present Value	5 Year Life
Annual Royalty	$100,000
Useful Life	5 years
Discount Rate	10%
PV of Patent	$379,079

Depreciation				5 Year Life
Patent Value / Useful Life	=	$379,079 / 5 years	=	$75,816

Making Unreasonable, Arbitrary and Unsubstantiated Income Allocations

The valuation process for many intangible assets is based on incremental income analysis, which uses a discounted income stream. Discounted income or cash flow analyses are acceptable methods of valuation. However, the assumptions of the amount of income associated with an asset, the discount rate and the length of the income stream must be reasonable.

Watch for reports where the aggregate income streams of intangible assets acquired is larger than the historical income of the enterprise. Another area that must be scrutinized carefully is the use of risk-free or nearly risk-free rates to discount the income stream.

Determining the Source of Cash Flow

If discounted cash flow is used, it will include depreciation. Make sure that the depreciation is the return of investment of the intangible asset being valued and is not depreciation from a tangible asset or another intangible asset.

In an overall acquisition of tangible and intangible assets, some taxpayers may be inclined to allocate more of the purchase price to tangible assets having a shorter recovery period under IRC § 168 than to intangible assets having a 15 year life. So, even with the enactment of legislation which provides for the amortization of most intangible assets, including goodwill, the valuation of individual assets is still an important aspect of proper income tax reporting.

Also, keep in mind that for GAAP purposes, taxpayers must separately value and assign proper useful lives to intangible assets acquired in the acquisition of a trade or business. You may want to request from the taxpayer a copy of the appraisal which was obtained for this purpose.

Summary

In this lesson we have listed some forms of intangible assets and described their characteristics. There are many valuation issues which arise with intangible assets.

Class Exercise

D, Inc., a mail order lingerie business, is sold by C to S (an unrelated party) for $2,500,000 in cash. Documentation in the file indicates that the negotiations were intense and long-lasting.

Information about the company and its competitors included the following information:

5 year average earnings	$200,000
Industry rate of return on tangible assets	8%
Industry rate of return on intangible assets	15%
Some comparable companies have recently sold for approximately 12 times their earnings.	
Delicate has no liabilities	

The purchase agreement allocated the assets as follows:

Asset Allocation	
Tangible assets	$2,000,000
Covenant not to compete	500,000
Total Assets	$2,500,000

C is 70 years old and fought for every penny because he had suffered a $3,000,000 NOL in a different business two years earlier. C has been an innovative and aggressive marketer in the very competitive mail order lingerie business for over 40 years. The file states that C has moved from New York to Florida where he is considering a lingerie mail order business with a southern flair.

Based on two appraisals and the agreement, S, the purchaser allocated $2,000,000 to tangible assets. The Service's appraisal valued the tangible assets at $1,000,000.

Is there goodwill and/or going concern value? If so how much? (Make any reasonable assumptions necessary.)

Lesson 14

Valuation of Notes

Contents

Introduction

Notes and mortgages are evidence of indebtedness. The valuation of notes and mortgages is an issue which is frequently encountered in Federal taxation.

Objective

At the end of this lesson, you will be able to determine the range of values for notes.

Valuation of Notes

In form, a note is a unilateral instrument in which the maker promises to pay the payee a specified sum at a specified time. It may have various attributes such as being secured, interest bearing, negotiable and payable on demand or at some time in the future. A mortgage is an interest in real property given to secure the payment of a note.

Notes constitute a significant element in many financial transactions. Although notes are often considered as being the equivalent of cash when received by a cash basis taxpayer, they nonetheless constitute property and not cash.

Income tax questions may arise in such areas as the valuation of a gift to a charitable organization or the computation of gain in a corporate liquidation where notes are distributed. These questions also arise in the sale of property for a note in a situation where the installment sales provisions are not applicable. In estate and gift tax, it is common to see notes as estate assets which are being transferred among family members.

For purposes of estate and gift tax valuation, the regulations provide that the value of a note is presumed to be unpaid principal plus accrued interest unless the taxpayer can establish a lower value. On the other hand, with the exception of those sales governed by the installment sales statutes, the income tax regulations have no similar provisions.

Though we might interpret this difference as creating two different standards of value, in reality the same principles of valuation are used for income tax and estate tax. Note that the Commissioner is entitled to a presumption of correctness. Because of this, the Courts have sustained the Service's determination of full face value where the taxpayer cannot meet this burden.

Additionally, the case law indicates that the same basic factors are considered relevant, regardless of the type of tax involved. Thus, our approach to note valuation will be directed to fair market value in the basic willing buyer—willing seller contest.

Factors and Approach to Note Valuation

The factors stated in the estate and gift tax regulations which may lead to a lower value are:

1. interest rate,
2. date of maturity,
3. full or partial uncollectibility based on the insolvency of the maker, or
4. the insufficiency of collateral property to satisfy the obligation.

There are other factors as well. Factors considered by the Courts were:

1. comparable sales,
2. whether the note qualified as a negotiable instrument, and
3. whether defenses, such as the statute of limitations on collection, could be raised.

The primary reasons for decreasing the value of notes are the loss of the use of the money owed and the risk of noncollection of principal and interest.

Discounts for Loss of Use of Money

A discount for loss of the use of the money owed generally results from an increase in interest rates. For example, when a fully secured loan is made there is virtually no risk of noncollection. As such, the interest being charged represents compensation for the use of the money. This "bargained for" interest rate probably represents the going rate for similar "safe" loans. However, due to a change in interest rates, the price of borrowing money may increase prior to the termination of the loan. At this point, the owner of the note has suffered a loss of investment opportunity since the note's yield is below the appropriate market rate. This results in the note having a fair market value that is less than its unpaid principal.

A commonly encountered problem in Federal taxation occurs when a reduced value is caused by the bargaining of the parties involved.

Example 1

> Able sells his business to Baker in an arm's length transaction for $500,000. Able received a negotiable note payable over 5 years at 12 percent interest. If this note represents a safe loan with minimal risk of noncollection, its true value is determined by comparison with similar safe notes. If the going interest rate for similar safe notes is 18 to 20 percent, then the face value of the note must be discounted to account for the interest rate differential.
>
> Since this was an arm's length transaction between unrelated parties, Able did not make a gift to Baker. Instead, the reduction to the note's value represents the fact that Able's business was probably worth less than $500,000.

In the above example, the valuation dispute will probably center around one of two points; determination of the going interest rate for other safe loans and determination of the discount.

In order to determine a safe rate, consideration should be given to the rates in effect for Government securities, prime commercial paper, and corporate bond yields with a similar maturity date. There will probably be no precise comparable, and, as such, an acceptable range should be developed. The calculation should be based upon present value factors and not a flat percentage reduction because the note is payable on a yearly basis.

Example 2

Using the same facts as Example 1, the calculation of value is determined using the two different methods as follows:

Present Value Method		
	Interest Rate	
	18%	20%
Face value of note	$500,000	$500,000
Factor (from actuarial table)	.87515	.83925
Value	437,575	419,625
Discount	12.5%	16%
Flat Discount Method		
Face value of note	$500,000	$500,000
Flat Discount Rate	18%	20%
Note rate	12%	12%
Difference		
Term remaining	6%	8%
Discount	x 5 years	x 5 years
Value	30%	40%
	$350,000	$300,000

The difference between the methods is dramatic. The fallacy of the second method becomes apparent if, instead of a 5-year term, a 17-year term is substituted. This would result in valuing the note at zero.

Risk of Noncollection

The second factor affecting note valuation is risk of noncollection of principal and interest. If a secured note is involved, then consideration must be given not only to amount but also the nature of the security. Where this security consists of high-grade, publicly traded securities or real estate, the primary concern is the ratio of security to the face value of the note. If recovery appears virtually certain in the event of default, then there is not risk.

Often, an on-going business is sold without third party financing. In this situation, the seller provides the purchase money by accepting a note for all or a substantial amount of the purchase price. The note is often secured by the business assets themselves. Careful consideration should be given to analyzing the financial statements and security agreement. Risky ventures may be sold on a nonrecourse basis. In such a situation, the noteholder's recourse is limited to the security. As such, the value of the security would be an indication of the note's value.

Where the maker is personally liable, then the financial position and business reputation of the maker should be evaluated. Furthermore, the Courts will consider the maker's repayment history, not only before, but also after, the valuation date. If a demand note is involved, primary consideration should be given to whether the maker has sufficient assets to immediately satisfy the obligation.

One factor specifically rejected by the Tax Court was the potential tax liability the note holder might incur upon sale of the note. Although recognizing that such a tax burden might well exist, the Court focused on the fact that the seller's tax liability would not enter into a buyer's consideration. Furthermore, the Court noted the myriad of factors that would have to be accounted for if potential Federal tax liability was to be considered.

After consideration of all factors affecting risk, an appropriate interest rate range should be determined. In determining the discount for risk, the going rate for a safe note should be calculated. This will represent the floor. In calculating the ceiling, consideration should be given to the yield for similar publicly traded debt instruments. In addition, any other factors increasing the risk of noncollection should be considered.

Valuation of Mortgage Notes

The same basic categories of discount, due to loss of the use of money and risk of noncollection, apply to mortgage notes. Even where a mortgage note is fully secured, a change in financial conditions could result in an inadequate return, and result in a discount to face value. Consideration should also be given to such factors as the value of real estate, the ratio of loan to land value, whether it is a first or second mortgage, and whether there is a market in the area for mortgages.

Summary

In this chapter we learned to value evidences of indebtedness.

In the next lesson we will briefly review the penalties associated with valuations.

Lesson 15

Penalties

Contents

Summary

Introduction

There are penalties that can be generated by adjustments to valuation issues. We will cover not only those penalties that deal exclusively with valuation issues, but also those penalties of general application that could be applicable to valuation issues. We will concentrate on changes to the law since the Omnibus Budget Reconciliation Act of 1989 (OBRA).

Objective

At the end of this lesson, you will be able to determine the applications of and exceptions to the various penalties that could be applicable to valuation.

IRC § 6662 — Imposition of Accuracy Related Penalty

OBRA consolidates into one Code section, IRC § 6662 (Exhibit 15-1) several different penalties:

1. the negligence penalty (Old IRC § 6653(a)),

2. the substantial understatement of income tax penalty (old IRC § 6661 – Substantial Understatement of Liability),

3. the substantial valuation overstatement penalty (old IRC § 6659 – Addition to Tax in the Case of Valuation Overstatements for Purposes of the Income Tax),

4. the substantial estate or gift tax valuation understatement penalty (old IRC § 6660 – Addition to Tax in the Case of Valuation Understatement for Purposes of Estate and Gift Taxes), and

5. the substantial overstatement of pension liabilities penalty (old IRC § 6659A – Addition to Tax in Case of Overstatements of Pension Liabilities).

These are referred to as the accuracy related penalties. All accuracy related penalties apply to returns due, without regard to extensions after December 31, 1989.

The old versions of these penalties have been repealed. The new versions of the penalties under IRC § 6662 have the same rate of 20 percent except with respect to underpayment attributable to one or more “gross valuation misstatements” as defined under IRC § 6662(h)(2). The penalty increases to 40% when there is a “gross valuation misstatement.”

Only the substantial valuation overstatement penalty of IRC § 6662(e) and the substantial estate or gift tax valuation understatement penalty under IRC § 6662(g) are limited to valuation issues. However, the other accuracy related penalties can be applicable to valuation issues. For example, there is nothing to prevent a negligence penalty under IRC § 6662(b)(1) from being applied to a valuation issue assuming the facts support negligence. This is important because the negligence penalty does not have a minimum threshold of $5,000, as do valuation penalties.

The IRC § 6662 penalties are determined on an issue by issue basis. Each of the accuracy related penalties is applied only to that part of the underpayment that is caused by the proscribed conduct.

Negligence

The negligence penalty, found at IRC §§ 6662(b) and 6662(c), is applied only to the portion of the underpayment that is attributable to negligence. This represents a change from prior law where the negligence penalty was applied to the entire underpayment. The definition of negligence remains the same as with prior law.

Substantial Valuation Overstatement

OBRA makes four main changes to this penalty.

1. the penalty can apply to all taxpayers.

2. a substantial valuation overstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent (up from 150 percent) or more of the correct value or adjusted basis.

3. the penalty applies only if the amount of the underpayment attributable to a valuation overstatement exceeds $5,000 ($10,000 for a corporation other than an S corporation or personal holding company). This is a major increase in the threshold as the former penalty required an understatement of only $1,000 (old IRC § 6659(d)).

4. the amount of this penalty is 20 percent of the underpayment if the value or adjusted basis is 200 percent or more but less than 400 percent of the correct value or adjusted basis, while the penalty is doubled to 40 percent if the value or adjusted basis is 400 percent or more of the correct value or adjusted basis.

This penalty is found in IRC §§ 6662(b)(3), 6662(f) and 6662(h).

Overstatement of Pension Liabilities

The substantial overvaluation of pension liabilities was changed to exist only if the valuation difference is 200 percent or more. The minimum underpayment for pension overvaluation to apply remains $1,000. The rate of the penalty is doubled to 40 percent if pension liabilities are overstated by 400 percent. See IRC §§ 6662(b)(4), 6662(f) and 6662(h).

Estate or Gift Tax Valuation Understatement

This penalty is based on the prior law penalty of IRC § 6660. OBRA modifies prior law by providing that a taxpayer is subject to the penalty only if the value of property that is reported on this return is 50 percent or less of the correct value. Under prior law the penalty applied to cases where .6666 (66 and 2/3 percent) or less of the correct value was reported. Moreover, the new law increases the threshold below which the penalty will not apply from $1,000 to $5,000. This penalty is found in IRC §§ 6662(b)(5), 6662(g) and 6662(h).

The rate of the penalty is 20 percent in normal cases; however, the rate will be doubled to 40 percent if 25 percent or less of the correct value is reported for estate and gift valuation.

The rules for this increase in the penalty are detailed under IRC § 6662(h).

IRC § 6664 — Definition and Special Rules

The penalties under IRC §§ 6662 and 6663 apply only if a return is filed. For this purpose, a return does not include a return filed under IRC § 6020(b) where the Service filed the return based on information available. Note that fraudulent failure to file a return is covered by IRC § 6651(f).

No accuracy related penalties will be imposed if there was reasonable cause for the underpayment and the taxpayer acted in good faith.

IRC § 6664(c)(2) states that the valuation overstatement penalty will not apply to charitable contribution property if:

(1) the claimed value was based on a qualified appraisal by a qualified appraiser as defined in Regulations under IRC § 170(a)(1), and

(2) in addition to the appraisal, the taxpayer made a good faith investigation of the value of the property.

The new law provides a standard definition of underpayment.

IRC § 6664 applies to returns with due dates after December 31, 1989, without regard to extensions.

Summary

In many of these cases you will be dealing with two issues: the valuation issue and the penalty issue. Remember that there can be some valuation penalties and other penalties which can apply to any case.

EXHIBIT 15-1

Part II — Accuracy-Related and Fraud Penalties

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Section
    6662.  Imposition of accuracy-related penalty.
    6663.  Imposition of fraud penalty.
    6664.  Definitions and special rules.
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§ 6662. Imposition of accuracy-related penalty

(a) Imposition of penalty.—— If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies. —— This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

(c) Negligence. —— For purposes of this section, the term “negligence” includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term “disregard” includes any careless, reckless, or intentional disregard.

(d) Substantial understatement of income tax. ——

(1) Substantial understatement. ——

(A) In general. —— For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of ——

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) Special rule for corporations. —— In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting “$10,000” for “$5,000”.

(2) Understatement. ——

(A) In general. —— For purposes of paragraph (1), the term “understatement” means the excess of ——

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

(B) Reduction for understatement due to position of taxpayer or disclosed item. –– The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to ––

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

(C) Special rules in cases involving tax shelters. ––

(i) In general. –– In the case of any item attributable to a tax shelter ––

(I) subparagraph (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) **Tax shelter.** –– For purposes of clause (i), the term "tax shelter" means ––

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(D) Secretarial list. –– The Secretary shall prescribe (and revise not less frequently than annually) a list of positions ––

(i) for which the Secretary believes there is not substantial authority, and

(ii) which affect a significant number of taxpayers.

Such list (and revision thereof) shall be published in the Federal Register.

(e) Substantial valuation misstatement under chapter 1. ––

(1) In general. –– For purposes of this section, there is a substantial valuation misstatement under chapter 1 if ––

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds $10,000,000.

(2) Limitation. —— No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

(3) Net section 482 transfer price adjustment. —— For purposes of this subsection ——

(A) In general. —— The term "net section 482 transfer price adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year form another taxable year) resulting from adjustments under section 482 in the price for any property or services (or for the use of property).

(B) Certain adjustments excluded in determining threshold. —— For purposes of determining whether the $10,000,000 threshold requirement of paragraph (1)(B)(ii) is met, there shall be excluded ——

(i) any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to any redetermination of a price if it is shown that there was a reasonable cause for the taxpayer's determination of such price and that the taxpayer acted in good faith with respect to such price, and

(ii) any portion of such net increase which is attributable to any transaction solely between foreign corporations unless, in the case of any of such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(C) Special rule. —— If the regular tax (as defined in section 55(c)) imposed by chapter 1 on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of this paragraph.

(f) Substantial overstatement of pension liabilities. ——

(1) In general. —— For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

(2) Limitation. —— No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

(g) Substantial estate or gift tax valuation understatement. ——

(1) In general. —— For purposes of this section, there is substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B is 50 percent or less of the amount determined to be the correct amount of such valuation.

(2) Limitation. —— No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

(h) Increase in penalty in case of gross valuation misstatements. ——

(1) In general. —— To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting “40 percent” for “20 percent”.

(2) Gross valuation misstatements. —— The term “gross valuation misstatements” means ——

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting ——

(i) “400 percent” for “200 percent” each place it appears,

(ii) “25 percent” for “50 percent”, and

(iii) “$20,000,000” for “$10,000,000”,

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting “400 percent” for “200 percent”, and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting “25 percent” for “50 percent”.

(Added Pub.L. 101-239, Title VII, § 7721(a), Dec. 19, 1989, 103 Stat. 2395, and amended Pub.L. 101-508, Title XI, § 11312(a), (b), Nov. 5, 1990, 104 Stat. 1388-454, 1388-455.)

Editorial Notes

Prior Provisions. A prior section 662, Act Aug. 16, 1954, c. 736, 68A Stat. 827, § 6659; May 14, 1960, Pub.L. 86-470, § 1, 74 Stat. 132; Dec. 30, 1969, Pub.L. 91-172, Title I, § 101(j)(51), 83 Stat. 531; Sept. 2, 1974, Pub.L , 93-406, Title II, § 1016(a)(19), 88 Stat. 931; renumbered §6660, Aug. 13, 1981, Pub.L. 97-34, Title VII § 722(a)(I), 95 Stat. 341; renumbered § 6662, Sept. 3, 1982, Pub.L. 97-248, Title III, § 323(a), 96 Stat. 613, directing that additions be treated as tax and setting the procedure for assessing certain additions to tax, was omitted in the general revision of accuracy-related penalties under Pub.L. 101-239. See section 6665 of this title.

Effective Date of 1990 Amendment. Section 11312(c) of Pub.L. 101-508 provided that: "The amendments made by this section [amending subsecs. (b)(3), (e) and (h)(2)(A) of this section] shall apply to taxable years ending after the date of the enactment of this Act [Nov. 5, 1990]."

Effective Date. Section applicable to returns the due date for which (determined without regard to extensions) is after Dec. 31, 1989, see section 7721(d) of Pub.L. 101-239, set out as a note under section 461 of this title.

§ 6663. Imposition of fraud penalty

(a) Imposition of penalty.— If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

(b) Determination of portion attributable to fraud. — If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.

(c) Special rule for joint returns. — In the case of a joint return, this section shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.

(Added Pub.L. 101-239, Title VII, § 7721(a), Dec. 19, 1989, 103 Stat. 2397.)

Editorial Notes

Effective Date. Section applicable to returns the due date for which (determined without regard to extensions) is after Dec. 31, 1989, see section 7721(d) of Pub.L. 101-239, set out as a note under section 461 of this title.

§ 6664. Definitions and special rules

(a) Underpayment.— For purposes of this part, the term "underpayment" means the amount by which any tax imposed by this title exceeds the excess of —

(1) the sum of —

(A) the amount shown as the tax by the taxpayer on his return, plus

(B) amounts not so shown previously assessed (or collected without assessment), over

(2) the amount of rebates made.

For purposes of paragraph(2), the term “rebate” means so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed was less than the excess of the amount specified in paragraph (1) over the rebates previously made.

(b) Penalties applicable only where return filed. —— The penalties provided in this part shall apply only in cases where a return of tax is filed (other than a return prepared by the Secretary under the authority of section 6020(b)).

(c) Reasonable cause exception. ——

(1) In general. —— No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

(2) Special rule for certain valuation overstatements. —— In the case of any underpayment attributable to a substantial or gross valuation overstatement under chapter 1 with respect to charitable deduction property, paragraph (1) shall not apply unless ——

(A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and

(B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

(3) Definitions. —— For purposes of this subsection ——

(A) Charitable deduction property. —— The term “charitable deduction property” means any property contributed by the taxpayer in a contribution for which a deduction was claimed under section 170. For purposes of paragraph (2), such term shall not include any securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

(B) Qualified appraiser. —— The term “qualified appraiser” means any appraiser meeting the requirements of the regulations prescribed under section 170(a)(1).

(C) Qualified appraisal. —— The term “qualified appraisal” means any appraisal meeting the requirements of the regulations prescribed under section 170(a)(1).

(Added Pub.L. 101-239, Title VII, § 7721(a), Dec. 19, 1989, 103 Stat. 2398.)

Editorial Notes

Effective Date. Section applicable to returns the due date for which (determined without regard to extensions) is after Dec. 31, 1989, see section 7721(d) of Pub.L. 101-239, set out as a note under section 461 of this title.

PART III —— APPLICABLE RULES

§ 6665. Applicable rules

(a) Additions treated as tax —— Except as otherwise provided in this title ——

(1) the additions to the tax, additional amounts, and penalties provided by this chapter shall be paid upon notice and demand and shall be assessed, collected, and paid in the same manner as taxes; and

(2) any reference in this title to "tax" imposed by this title shall be deemed also to refer to the additions to the tax, additional amounts, and penalties provided by this chapter.

(b) Procedure for assessing certain additions to tax. —— For purposes of subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift and certain excise taxes), subsection (a) shall not apply to any addition to tax under section 6651, 6654, or 6655; except that it shall apply ——

(1) in the case of an addition described in section 6651, to that portion of such addition which is attributable to a deficiency in tax described in section 6211; or

(2) to an addition described in section 6654 or 6655, if no return is filed for the taxable year.

(Added Pub.L. 101-239, Title, § 7721(a), Dec. 19, 1989, 103 Stat. 2399.)

Editorial Notes

Effective Date. Section applicable to returns the due date for which (determined without regard to extensions) is after Dec. 31, 1989, see section 7721(d) of Pub.L. 101-239, set out as a note under section 461 of this title.

SUBCHAPTER B — ASSESSABLE PENALTIES

Part

PART I —— GENERAL PROVISIONS

Section

§ 6700. Promoting abusive tax shelters, etc.

(a) Imposition of penalty.—— Any person who ——

(1)(A) organizes (or assists in the organization of) ——

(i) a partnership or other entity,
(ii) any investment plan or arrangement, or
(iii) any other plan or arrangement, or

(B) participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement referred to in subparagraph (A), and

(2) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale) ——

(A) a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or

(B) a gross valuation overstatement as to any material matter,

shall pay, with respect to each activity described in paragraph (1), a penalty equal to the $1,000 or, if the person establishes that it is lesser, 100 percent of the gross income derived (or to be derived) by such person from such activity. For purposes of the preceding sentence, activities described in paragraph (1)(A) with respect to each entity or arrangement shall be treated as a separate activity and participation in each sale described in paragraph (1)(B) shall be so treated.

(b) Rules relating to penalty for gross valuation overstatements. ––

(1) Gross valuation overstatement defined. –– For purposes of this section, the term "gross valuation overstatement" means any statement as to the value of any property or services if ––

(A) the value so stated exceeds 200 percent of the amount determined to be the correct valuation, and

(B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 to any participant.

(2) Authority to waive. –– The Secretary may waive all or any part of the penalty provided by subsection (a) with respect to any gross valuation overstatement on a showing that there was a reasonable basis for the valuation and that such valuation was made in good faith.

(c) Penalty in addition to other penalties. –– The penalty imposed by this section shall be in addition to any other penalty provided by law.

(Added Pub.L. 97-248, Title III, § 320(a), Sept. 3, 1982, 96 Stat. 611, and amended Pub.L. 98-369, Title I, § 143(a), July 18, 1984, 98 Stat. 682; Pub.L. 101-239, Title VII, § 7734(a), Dec. 19, 1989, 103 Stat. 2403.)

Editorial Notes

Effective Date of 1989 Amendment. Section 7734(b) of Pub.L. 101-239 provided that: "The amendments made by this section [amending subsec. (a) of this section] shall apply to activities after December 31, 1989."

Effective Date of 1984 Amendment. Section 143(c) of Pub.L. 98-369 provided that: "The amendments made by this section [amending subsec. (a) of this section and section 7408 of this title] shall take effect on the day after the date of enactment of this Act [July 18, 1984]."

Effect Date. Section 320(c) of Pub.L. 97-248 provided that: "The amendments made by this section [enacting this section] shall take effect on the day after the date of the enactment of this Act {Sept. 3, 1982]."

Lesson 16

Appraisal Report

Contents

Summary of Necessary Factors
Company Background
Checklists
Summary

Introduction

The amendments to the IRC made in the Tax Reform act of 1984 increased the importance of the appraisal for valuation issues and introduced new requirements the appraisal must meet to be adequate for tax purposes. One major change is that the appraisal became a requirement in deductions for charitable contributions under IRC § 170.

As you read in the lesson, you will want to refer to the Pratt text, Chapter 14, which reproduces a sample appraisal of the stock in **JMK Inc.**, a company which is part of an estate. **JMK** is a retailer of electronics. Review the appraisal to see where the items discussed appear.

Objectives

At the end of this lesson, you will be able to:

1. Review an appraisal report and select the significant aspects of the report.

2. Determine from the appraisal report whether the appraiser meets the qualification requirements of the Code.

3. Determine the accuracy and consistency of the appraisal report.

Background

An appraisal is an opinion of value based on the experience and knowledge of the person offering the opinion.

The Service attempted to provide guidance for what should be included in a proper appraisal in Rev. Proc. 66-49, **Exhibit 16-1**. The 1984 Act highlighted and mandated some of these provisions so that much of what was suggested in 1966 became required after 1984.

It is suggested that whether the asset to be appraised is real estate, closely held stock or some other asset with specific and/or unique characteristics, that the appraisal include a statement that the appraiser did make a personal inspection of the property to familiarize himself with specific problems involved in appraising the asset involved. A good one should contain a statement of independence stating that the appraiser has no present or contemplated interest in the property, or, if so, an explanation of the interest.

Under IRC § 170, an appraisal is required if the amount claimed as a charitable deduction exceeds $5,000 for any single item of such property ($10,000 in the case of a donation of stock other than publicly traded securities), or in the aggregate for similar types of property.

The Appraisal Report

The appraisal should contain:

1. A description of the property.

2. The fair market value of the property on the valuation date and the specific reason or reasons why the appraiser reached his or her conclusion.

3. The qualifications of the appraiser.

4. The signature and tax identification number of the appraiser.

5. The name of the entity being appraised spelled out completely and accurately.

6. For a business interest, the form of organization (regular corporation, S corporation, general partnership, limited partnership, etc.).

7. The state in which the entity is incorporated or registered.

8. The interest in the entity being appraised clearly indicated (100 percent of the common stock; 5,000 shares of common stock out of 100,000 shares outstanding; a 40 percent general partnership interest; the value of certain assets for an asset sale; etc.).

9. The purpose of the appraisal (sale of interest, federal estate tax liability, employee stock ownership plan, marital dissolution, etc.).

Approaches to the Appraisal

It is also important to analyze the approaches to valuation from the standpoint of:

1. Selection of valuation approaches,

2. Satisfactory alternative approaches. Is there a satisfactory explanation why other approaches are not used?

3. Is the approach to the valuation consistent with the purpose and expressed limitations of the appraisal?

Appraisal of Business Equity Interest

The appraisal should also contain a description of the interest being valued.

1. The number of shares outstanding and each class of stock or partnership interest should be clearly described.

2. The distribution of ownership should be clearly described. (The appraisal should contain a list of major owners, usually those owning over 10% of the stock, number of

other owners broken down by class of ownership interest if more than one class of stock or other interest).

Summary of Necessary Factors

Some other factors should be considered when considering an appraisal report of an equity interest. These factors include, but are not limited to the following:

1. Percentage of ownership interest and voting rights.

2. Degree of control.

3. Degree of liquidity.

4. Was the data used in the appraisal available as of date of valuation?

5. Can the discount rates, capitalization rates and multipliers that were used in the report be justified?

6. Are weightings of various factors justified?

7. What consideration was given to capital requirements?

8. Have debt/equity ratios between the subject company and comparative companies been considered adequately?

9. What is the potential dilution and degree of risk?

Company Background

The appraisal should contain additional basic material on company background and operations, such as:

1. Brief history of company leading to its present condition,

2. Location(s) of operations,

3. Product/services lines,

4. Markets served,

5. Customer base (type, degree of concentration),

6. Competition,

7. Position of subject company relative to its industry (this is very important; i.e., is it a leader in its industry?),

8. Competitive strengths and weaknesses (uniqueness of product, quality, service, price, location, etc.),

9. Description of facilities (site, plants, equipment, etc.),

10. Management and workforce (size of work force, description and degree of dependence on key personnel, the latter especially if highly dependent on one or a few key people),

11. If there are subsidiaries, affiliates or significant interest in other entities, the relationships (percentage ownerships, methods of accounting basis for transfer pricing, etc.) should be clearly described,

12. Overall, the positive and negative aspects of the company's operations and resources should be summarized.

Checklists

A checklist or test for the quality and consistency of any appraisal is as follows:

Does the appraisal report maintain **internal consistency**?

1. Are all statements made in any part of the report consistent with statements made in any other part of the report?

2. If statements are made concerning approaches to be used, factors to be considered, etc., were all such approaches and factors used or considered as stated?

3. Is the conclusion consistent with all statements made and procedures used to lead up to that conclusion?

4. Do the approaches and procedures used conform to the definition of the standard of value, including relevant case law, if applicable?

5. Are all numbers, spellings, etc., consistent throughout the report?

6. Do all headings in the Table of Contents and Lists of Tables, Exhibits, Appendices, etc., conform exactly to headings in the body of the report?

7. Are the calculations accurate?

A checklist on the type of information about the subject company that is necessary to develop a corporate stock valuation is contained in **Exhibit 16-3.**

Summary

The requirements for appraisals were discussed in this lesson. The lists of factors to look for are meant to give guidance when reviewing an appraisal report, but are not meant to be all inclusive.

EXHIBIT 16-1

(Also Part I, Section 170; 26 CFR 1.170-1.)   Rev. Proc. 66-49

A procedure to be used as a guideline by all persons making appraisals of donated property for Federal income tax purposes.

SECTION 1. PURPOSE.

The purpose of this procedure is to provide information and guidelines for taxpayers, individual appraisers, and valuation groups relative to appraisals of contributed property for Federal income tax purposes. The procedures outlined are applicable to all types of noncash property for which an appraisal is required such as real property, tangible or intangible personal property, and securities. These procedures are also appropriate for unique properties such as art objects, literary manuscripts, antiques, etc., with respect to which the determination of value often is more difficult.

SECTION 2. LAW AND REGULATIONS.

.01 Numerous sections of the Internal Revenue Code of 1954, as amended, give rise to a determination of value for Federal tax purposes; however, the significant section for purposes of this Revenue Procedure is section 170, Charitable, Etc., Contributions and Gifts.

.02 Value is defined in section 1.170-1(c) of the Income Tax Regulations as follows:

> * * *.The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. * * *

.03 This section further provides that:

> * * *.If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the lowest usual market in which he customarily sells, at the time and place of contribution (and in the case of a contribution of goods in quantity, in the quantity contributed). * * *

.04 As to the measure of proof in determining the fair market value, all factors bearing on value are relevant including, where pertinent, the cost, or selling price of the item, sales of comparable properties, cost of reproduction, opinion evidence and appraisals. Fair market value depends upon value in the market and not on intrinsic worth.

.05 The cost or actual selling price of an item within a reasonable time before or after the valuation date may be the best evidence of its fair market value. Before such information is taken into account, it must be ascertained that the transaction was at arm’s length and that the parties were fully informed as to all relevant facts. Absent such evidence, even the sales price of the item in question will not be persuasive.

.06 Sales of similar properties are often given probative weight by the courts in establishing fair market value. The weight to be given such evidence will be affected by the degree of similarity to the property under appraisal and the proximity of the date of sale to the valuation date.

.07 With respect to reproductive cost as a measure of fair market value, it must be shown that there is a probative correlation between the cost of reproduction and fair market value. Frequently, reproductive cost will be in excess of the fair market value.

.08 Generally, the weight to be given to opinion evidence depends on its origin and the thoroughness with which it is supported by experience and facts. It is only where expert opinion is supported by facts having strong probative value, that the opinion testimony will in itself be given appropriate weight. The underlying facts must corroborate the opinion; otherwise such opinion will be discounted or disregarded.

.09. The weight to be accorded any appraisal made either at or after the valuation date will depend largely upon the competence and knowledge of the appraiser with respect to the property and the market for such property.

SECTION 3. APPRAISAL FORMAT.

.01 When it becomes necessary to secure an appraisal in order to determine the values of items for Federal income tax purposes, such appraisals should be obtained from qualified and reputable sources, and the appraisal report should accompany the return when it is filed. The more complete the information filed with a tax return the more unlikely it will be that the Internal Revenue Service will find it necessary to question items on it. Thus, when reporting a deduction for charitable contributions on an income tax return, it will facilitate the review and the acceptance of the returned values if any appraisals which have been secured are furnished. The above-mentioned regulations prescribe that support of values claimed should be submitted and a properly prepared appraisal by a person qualified to make such an appraisal may well constitute the necessary substantiation. In this respect, it is not intended that all value determinations be supported by formal written appraisals as outlined in detail below. This is particularly applicable to minor items of property or where the value of the property is easily ascertainable by methods other than appraisal.

.02 In general, an appraisal report should contain at least the following:

(1) A summary of the appraiser's qualifications.

(2) A statement of the value and the appraiser's definition of the value he has obtained.

(3) The basis upon which the appraisal was made, including any restrictions, understandings, or covenants limiting the use or disposition of the property.

(4) The date as of which the property was valued.

(5) The signature of the appraiser and the date the appraisal was made.

.03 An example of the kind of data which should be contained in a typical appraisal is included below. This relates to the valuation of art objects, but a similar detailed breakdown can be outlined for any type of property. Appraisals of art objects, paintings in particular, should include:

(1) A complete description of the object, indicating the size, the subject matter, the medium, the name of the artist, approximate date created, the interest transferred, etc.

(2) The cost, date, and manner of acquisition.

(3) A history of the item including proof of authenticity such as a certificate of authentication if such exists.

(4) A photograph of a size and quality fully identifying the subject matter, preferably a 10″ x 12″ or larger print.

(5) A statement of the factors upon which the appraisal was based, such as:

(a) Sales of other works by the same artist particularly on or around the valuation date.

(b) Quoted prices in dealers' catalogs of the artist's works or of other artists of comparable stature.

(c) The economic state of the art market at or around the time of valuation, particularly with respect to the specific property.

(d) A record of any exhibitions at which the particular art object had been displayed.

(e) A statement as to the standing of the artist in his profession and in the particular school or time period.

.04 Although an appraisal report meets these requirements, the Internal Revenue Service is not relieved of the responsibility of reviewing appraisals to the extent deemed necessary.

Section 4. Review of Valuation Appraisals.

.01 While the Service is responsible for reviewing appraisals, it is not responsible for making appraisals; the burden of supporting the fair market value listed on a return is the taxpayer's. The Internal Revenue Service cannot accord recognition to any appraiser or group of appraisers from the standpoint of unquestioned acceptance of their appraisals. Furthermore, the Service cannot approve valuations or appraisals prior to the actual filing of the tax return to which the appraisal pertains and cannot issue advance rulings approving or disapproving such appraisals.

.02 In determining the acceptability of the claimed value of the donated property, the Service may either accept the value claimed based on information or appraisals submitted with the return or make its own determination as to the fair market value. In either instance, the Service may find it necessary to:

(1) contact the taxpayer and ask for additional information,

(2) refer the valuation problem to a Service appraiser or valuation specialist,

(3) recommend that an independent appraiser be employed by the Service to appraise the asset in question. (This latter course is frequently used by the Service when objects requiring appraisers of highly specialized experience and knowledge are involved.)

EXHIBIT 16-2

Section 170. —— Charitable, Etc. Contributions and Gifts

26 CFR 1.170A-1: Charitable etc., contributions and gifts, allowance of deduction.

Charitable contribution; valuation; donor-imposed restriction on use. When a donor places a restriction on the use of property, the amount of the charitable contribution deduction is the fair market value of the property at the time of the contribution determined in light of the restriction.

Rev. Rul. 85-99

ISSUE

Under the described conditions, is the amount of a charitable contribution deduction affected by a restriction placed by the donor on the use of the donated property?

FACTS

An agricultural college sought to acquire a certain parcel of land to use in connection with its operations in farming research and development of new farming techniques. The college is an organization described in section 501(c)(3) and 170(c) of the Internal Revenue Code. In 1982, the owner of the property, an individual, gave 50 acres of a 100-acre parcel of land to the college under a deed of gift that carried a restrictive covenant providing that the land be used for agricultural purposes only. The donor retained the remaining 50 acres but retained no interest in the donated property. Use of the land for agricultural purposes would not result in a special benefit to the donor. The highest and best use of the land was for a more valuable use than agricultural purposes.

LAW AND ANALYSIS

Section 170(a) of the Code provides that there shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made in the taxable year.

Section 1.170A-1(c) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided by section 170(e)(1) of the Code and section 1.170A-4(a) of the regulations.

Although the highest and best use of the contributed property, if unencumbered, would be for a more valuable use than as agricultural land, the deed of gift to the land carried a restrictive covenant providing that the land be used solely for agricultural purposes.

The value of property contributed under section 170 is the price that a reasonably knowledgeable willing buyer would pay a reasonably knowledgeable willing seller for the property subject to any restrictions imposed at the time of the contribution. See section 1.170A-1(c) of the regulations. Property otherwise intrinsically more valuable that is encumbered by some restriction or condition limiting its marketability or use, must be valued in the light of such limitation. See *Cooley v. Commissioner*, 33 T.C. 223, 225 (1959), aff'd per curiam, 238 F.2d 945 (2d Cir. 1960); *Deukmejian v. Commissioner*, T.C.M. 1981-24; *Silverman v. Commissioner*, T.C.M 1968-216; *Klopp v. Commissioner*, T.C.M. 1960-185; *Dresser v. Commissioner,* T.C.M. 1956-54.

HOLDING

Subject to the reductions imposed by section 170(e)(1) of the Code, the amount of the taxpayer donor's charitable contribution deduction is the fair market value of the property at the time of the contribution determined in the light of the restriction placed by the donor on the use of the property.

EXHIBIT 16-3

Information Questionnaire

Corporate Stock Valuation

The most important requirement to producing a credible and supportable valuation report is background and financial data for the company to be valued. In order to assist you in evaluating a company and to speed processing of your requests for a fair market determination of a business interest or stock valuation, the following list has been developed. This corporate background information should be obtained from the taxpayer's representatives. The list is not inlcusive, and upon analysis of this information, it may be necessary to develop additional facts.

We also recommend that you contact the chief of the Financial and Engineering Section of the Office of Appraisal Services in National Office to discuss the services that it can provide in the areas of stock and business valuations.

These are guidelines only and not all of this material will be available in every case.

1. Obtain a description of the company's business. Has the nature of the company's business changed or evolved since its inception? Did it intend to place future emphasis on different market or business segments (as of the valuation date)?

2. What geographic areas does the company serve? Are there any limitations on what markets can be reached, e.g., freight, duties, service maintenance, patent licenses, tariffs, government regulation, etc.? Did the company intend to enlarge its present areas of distribution or service as of the valuation date?

3. Please describe the major products or services of the company.

4. Obtain a 3-year record of names, addresses, and volume of purchases of major customers or outlets for the company's products or services. List the names of customers who account for more than 10% of the company's business. Would their loss be deleterious to the company?

5. Obtain the names of the company's major competitors: describe the nature and area of their competition — is it direct or indirect? What is the company's approximate rank in the industry? Are there numerous competitors? What is the degree of competition? Can new companies readily enter the field? Do the company's competitors possess greater financial resources? Are they longer established and better recognized?

6. Obtain a schedule of all acquisitions of other companies, assets, personnel, etc., made by the company, or any intended acquisitions. Please furnish copies of all acquisition agreements.

7. Has the company made:

    a. any private placements of its equity or debt securities, or

    b. any public sale of its equity or debt securities?

    If so, obtain complete details including copies of documents used in the placement and/or sale.

8. Obtain the following data regarding the distribution of the company's voting stock:

    a. classes of stock and number of shares of each outstanding;

    b. total number of shareholders plus a list of shareholders;

    c. names, residence addresses and shareholdings of ten largest shareholders in each class;

    d. relationships of major shareholders to each other or to the officers and directors of the company; and

    e. details of any voting trust agreements, shareholders agreements or other arrangements to vote stock jointly.

9. Does the company have any long-term or short-term debt, secured or unsecured, or has the company guaranteed such debt on behalf of others? Obtain copies of the documents creating the debt of guarantee, or describe the debt or guarantee.

10. Obtain the audited financial statements (with the notes attached) for the last five years and the Federal income tax returns for the last three years.

11. Obtain interim statements covering the period subsequent to the last audited financial statement.

12. Obtain an explanation of any and all abnormal, nonrecurring or unusual items in earnings statements or balance sheets.

13. Obtain a statement of cash flow if materially different from statement of net earnings.

14. Obtain a statement as to any contingent or possible liabilities not shown on balance sheet. Please include guarantees, warranties, litigation, off-balance sheet financials, etc.

Lesson 17

Valuation Problem

Contents

Objectives
Facts
Questions

Objective

At the end of this lesson, you will be able to apply the valuation principles and techniques learned to a given set of facts.

Facts

Orchids, Inc. is a closely held corporation established in 1958. Orchids, Inc. is in the business of hybridizing and selling orchids. Jane Baker is the president of the corporation and owns 51 percent of the stock of Orchids.

Sally Smith operates Charity, Inc., the retail subsidiary. Sally has a Ph.D. in botany from Harvard, is an established author in her field, and has dominated the field of orchid hybridizing worldwide for the last 50 years. She owns 49 percent of the stock of Orchids.

Jane's two sons, Mark and Anthony, each own 300 shares of Charity, Inc. (33 1/3 each) and are vice presidents in charge of production and marketing, respectively. Orchids, Inc., owns the other 300 shares.

The financial statements of Orchid, Inc. and Charity, Inc. are included in the following pages along with selected financial information and data.

Orchids, Inc.
Balance Sheet
December 31, 1992

ASSETS

Current Assets:		
Cash	$ 500,000	
Acc'ts. Receivable	2,400,000	
Inventories[1]	3,000,000	
Marketable Securities (at market)	8,000,000	
Bonds (at market)	10,000,000	
Certificate of Deposit	2,500,000	
Total Current Assets		$26,400,000
Investments:		
Investment in Charity, Inc. (at cost)[2]	$ 50,000	
Stock (at cost)[3]	500,000	
Cash Surrender Value of Life Insurance Policy (2,000,000 face)	650,000	
Total Investments		$1,200,000
Fixed Assets:		
Land (at cost)	$ 100,000	
Buildings	3,000,000	
Equipment	500,000	
Less: Accumulated Depreciation	(500,000)	
Total Fixed Assets		3,100,000
TOTAL ASSETS		$30,700,000

Orchids, Inc.
Balance Sheet
December 31, 1992

LIABILITIES		
Current Liabilities:		
Accounts Payable	$ 900,000	
Mortgage Payable – current year	1,000,000	
Total Current Liabilities		$1,900,000
Long-term Liabilities		
Mortgage Payable	2,000,000	
Total Long-Term Liabilities		2,000,000
		$3,900,000
STOCKHOLDERS' EQUITY		
Common stock (100 shares issued and outstanding, $100 par value)	$ 800,000	
Paid-in Surplus	2,000,000	
Retained Earnings	24,000,000	
TOTAL STOCKHOLDER'S EQUITY		$26,800,000
TOTAL LIABILITIES AND EQUITY		$30,700,000

The land, which is carried at a cost of $100,000, consists of 720 acres, in 16 noncontiguous parcels which vary in size from 30 to 50 acres each.

The operating facility is located on a 20-acre parcel. Comparable sales of properties, none of which are over 50 acres, have been made at $4,000 to $5,000 per acre.

However, a single 150-acre parcel sold two years ago for $2,000 per acre. The land is zoned for agricultural use only.

The investment in stock represents 500,000 shares in Manure, Inc., a publicly traded corporation in the business of manufacture and sale of fertilizer. The stock is publicly traded at $5 per share. Orchids, Inc., obtained the block of stock on January 21, 1991. The stock was subject to an investment letter.

Manure, Inc. has 40,000 shares outstanding. The weekly volume of sales on the stock market for the four weeks preceding the valuation date was 499,900 shares.

The combined tax rate for 1992 was 50%.

Orchids, Inc.
Income Statement
Year Ended December 31, 1992

Net Sales	$12,000,000
Less: Cost of Goods Sold	(8,400,000)
Gross Profit	3,600,000
Selling, General and Administrative Expenses[4]	(1,600,000)
Operating Profit	2,000,000
Other Income	2,000,000
Capital Gain on Sale of Securities	500,000
Other Deductions[5]	
(Casualty loss — 300,000)	
	(300,000)
Income before income taxes	4,200,000
Income taxes — 50% rate	(2,100,000)
Net Income After Taxes	$ 2,100,000
Dividends Paid	$ 100,000

Orchids, Inc. Selected Statistics From Prior Four Years' Income Statements				
	1991	**1990**	**1989**	**1988**
Net Sales	$11,000,000	$10,000,000	$9,000,000	$8,000,000
Cost of Goods Sold	7,700,000	7,000,000	6,300,000	5,600,000
Gross Profit	3,300,000	3,000,000	2,700,000	2,400,000
Net Income from Operations	1,900,000	1,850,000	1,800,000	1,750,000
Other Income	1,800,000	1,800,000	1,600,000	1,600,000
Total net income	3,700,000	3,650,000	3,400,000	3,350,000
Income after taxes	$ 1,850,000	$ 1,825,000	$ 1,700,000	$ 1,675,000
Dividends Paid	$ 100,000	$ 100,000	$ 100,000	$ 100,000

Orchids, Inc.

Notes to the Financial Statements

1. Inventory at FIFO which approximates market value.
2. Investment in Charity, Inc. — 33 1/3%.
3. Stock — 500,000 shares letter stock in Manure, Inc., a listed company, at a cost of $1 per share, currently trading at $5 per share. Stock acquired in 1991 with a letter of investment intent.
4. Officer salaries $1,000,000 in 1992.
5. Deductions —
   - casualty loss $300,000 (from freeze damage to plants)

Charity, Inc. is a retail orchid sales subsidiary of Orchids, Inc., with one outlet. The balance sheets and income statements are below. Charity, Inc. pays no dividends.

Orchids, Inc.
Balance Sheet
December 31, 1992

ASSETS		
Current Assets:		
Cash	$ 200,000	
Inventories	800,000	
Total Current Assets		$1,000,000
Fixed Assets:		
Furniture and Fixtures	100,000	
Total Fixed Assets		$ 100,000
TOTAL ASSETS		$1,100,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Rent Payable	$ 40,000	
Accounts Payable	20,000	
Total Current Liabilities		$ 60,000
Long-Term Liability		
Long-Term Lease (10-year)	$240,000	
Total Long-term Liabilities		240,000
Total Liabilities		$ 300,000
STOCKHOLDERS' EQUITY		
Common stock (no par)		
(900 shares issued and outstanding)	$ 90,000	
Retained Earnings	710,000	
TOTAL STOCKHOLDERS' EQUITY		800,000
TOTAL LIABILITIES AND EQUITY		$1,100,000

Charity, Inc. Income Statement Years Ended December 31, 1990-1992			
	1992	**1991**	**1990**
Net Sales	$2,400,000	$2,200,000	$2,000,000
Less: Cost of Goods Sold	(1,200,000)	(1,100,000)	(1,000,000)
Gross Profit	1,200,000	1,100,000	1,000,000
Less: Operating Expenses	(800,000)	(750,000)	(700,000)
Net Profit	400,000	350,000	300,000
Tax	(200,000)	(175,000)	(150,000)
Net Profit After Tax	$ 200,000	$ 175,000	$ 150,000

Only two sales of companies could be found that were comparable to Orchids, Inc. Information on the comparables has been analyzed and is presented in the following table.

	Orchid Mart, Inc.	**Unique Orchids Co.**
Current Ratio	3.3	3.5
Book value per share	$45.00	$75.00
Current year's EPS	2.75	3.90
5 years average EPS	2.20	3.50
Dividends per share	1.10	1.25
Market Price	$30.00	$55.00

Market Comparable Data			
	Orchid Mart, Inc.	**Unique Orchids, Inc.**	**Average**
Current year	10.90	14.1	12.5
5-year average	13.63	15.71	14.67
Price/Book Value	.66%	.73%	69.5%
Dividend Yield	3.6%	2.3%	3.0%
Dividend Payout ratio	40.0%	32.0%	36.0%

No comparables could be found for Charity, Inc., but retail florists sell in the area where Charity is located at one times annual sales or five times annual net profit. These comparable companies have no significant nonoperating assets.

Questions

1. Compute the value of Orchids, Inc. as of December 31, 1992.

2. What is the value of Jane's 51 percent share of Orchids?

3. What is the value of Sally's 49 percent share of Orchids?

[No references to footnotes provided.]

Glossary

Key

[a] Definitions of terms adopted by the Business Valuation Committee of the American Society of Appraisers.

[b] *Black's Law Dictionary*

[w] *Webster's New World Dictionary*

[d] *Dictionary of Real Estate Appraisers*

Adjusted Book Value:

[a] The book value which results after one or more asset or liability amounts are added, deleted, or changed from the respective book amounts.

Advertiser:

[w] One who tells about or praises (a product, service, etc.) publicly (through radio, newspaper, television, etc.), so as to make people want to buy it; call people's attention to a product.

[b] Basically the same definition.

Agency:

[w] An organization that offers a particular kind of assistance; the business of any person, firm, etc. empowered to act for another; an administrative division of government with specific functions.

[b] Includes every relation in which one person acts for or represents another by latter's authority.

Appraisal:

[a] The act or process of determining value. It is synonymous with valuation.

Appraisal Date:

[a] The date as of which the appraiser's opinion of value applies.

Appraisal Method:

[a] A specific procedure applied to determine value.

Appraisal Value:

[a] The appraiser's opinion or determination of value.

Assembled:

[w] Gathered into a group; collected; parts fit together.

[b] Parts collected or gathered together and placed in their proper relation to each other.

Basis:

[d] Income taxation, the portion of total property value most likely to be affected by depreciation or capital improvement.

Book Value:

[a] 1. With respect to assets, the capitalized cost of an asset less accumulated depreciation, depletion or amortization as it appears on the books of account of the enterprise.

2. With respect to a business enterprise, the difference between total assets (net of depreciation, depletion and amortization) and total liabilities of an enterprise as they appear on the balance sheet. It is synonymous with net book value, net worth and shareholders' equity.

Business Appraiser:

[a] A person who by education, training and experience is qualified to make an appraisal of a business enterprise and/or its intangible assets.

Business Enterprise:

[a] A commercial, industrial or service organization pursuing an economic activity.

Business Valuation:

[a] the act or process of arriving at an opinion or determination of the value of a business enterprise or an interest therein.

Capital Structure:

[a] The composition of the invested capital.

Capitalization:

[a] 1. The conversion of income into value.

2. The capital structure of a business enterprise.

3. The recognition of an expenditure as a capital asset rather than a period expense.

Capitalization Factor:

[a] Any multiple or divisor used to convert income into value.

Capitalization Rate:

[a] Any divisor (usually expressed as a percentage) that is used to convert income into value.

Cash Flow:

[a] Net income plus depreciation and other non-cash charges.

Contract:

[w] An agreement between two or more people to do something, especially one formally set forth in writing and enforceable by law; compact; covenant.

[b] A promissory agreement between two or more persons that creates, modifies, or destroys a legal relation.

Control:

[a] The power to direct the management and policies of an enterprise.

Control Premium:

[a] The additional value inherent in the control interest, as contrasted to a minority interest, that reflects its power of control.

Copyright:

[w] The exclusive right to the publication, production, or sale of the rights to a literary, dramatic, musical, or artistic work, or to the use of a commercial print or label granted by law for a specified period of time to an author, composer, artist, distributor, etc.

[b] The right of literary property as recognized and sanctioned by positive law.

Cost Approach:

[d] Approach through which an appraiser derives a value indication of the fee simple interest in a property by estimating the current cost to construct a reproduction of or replacement for the existing structure, deducting for all evidence of accrued depreciation from the cost new of the reproduction or replacement structure, and adding the estimated land value plus an entrepreneurial profit. Adjustments may be made to the indicated fee simple value of the subject property to reflect the value indication of the property interest being appraised.

Covenant:

[w] A formal, sealed contract; a clause of such a contract; a suit for damages for violation of such a contract.

[a] A promise, between two or more parties, incorporated in a trust indenture or other formal instrument, to perform certain acts or to refrain from the performance of certain acts.

[b] An agreement, convention, or promise of two or more parties, by deed in writing, signed, sealed, and delivered, by which either of the parties pledges himself to the other that something is either done or shall be done, or stipulates for the truth or certain facts.

Customer:

[w] Any person with whom one has dealings; a person who buys, especially buys from or patronizes, an establishment regularly.
[b] One who regularly or repeatedly makes purchases of, or has business dealings with a tradesman or business house.

Depreciation:

[d] 1. In appraising, a loss in property value from any cause; any difference between reproduction cost or replacement cost and market value as of the date of appraisal.

2. In regard to improvements, deterioration and obsolescence.

3. In accounting, an allowance made against the loss in value of an asset for a defined purpose and computed using a specified method.

Discount Rate:

[a] A rate of return used to convert a monetary sum, payable or receivable in the future, into present value.

Economic Life:

[a] The period over which property may be profitably used.

Equity:

[a] The owner's interest in property after deduction of all liabilities.

Expiration:

[w] A formal termination on a closing date, as of a contract or subscription.

[b] Cessation; termination from mere lapse of time; as the expiration of a lease, statute, and the like.

Fair Market Value:

[a] The amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.

Synonymous with market value — the most probable price in terms of money which a property should bring in competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus.

[b] Price at which a willing seller and a willing buyer will trade.

Favorable:

[w] Helpful or advantageous, approving.

[b] Regarded with favor; aiding or having the disposition to aid; shown partiality or unfair bias towards.

Franchise:

[w] Any special right, privilege, or exemption granted by the government, as to be a corporation, operate a public utility, etc.; the right to market a product or provide a service, often exclusive for a specified area, as granted by a manufacturer or company.

[a] A privilege or right conferred by grant upon an individual or group of individuals. Usually, an exclusive privilege or right to furnish public services or sell a particular product in a certain community.

[b] A special privilege conferred by government on individual or corporation, and which does not belong to citizens of country generally of common right.

Going Concern:

[a] An operating business enterprise.

Going Concern Value:

[a] 1. The value of an enterprise, or an interest therein, as a going concern.

2. Intangible of value in a business enterprise resulting from factors such as having a trained workforce, an operational plant, and the necessary licenses, systems and procedures in place.

Goodwill:

[a] That intangible asset that arises as a result of name, reputation, customer patronage, location, products, and similar factors that have not been separately identified and/or valued but which generate economic benefits.

Highest and Best Use:

[d] The reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum profitability.

Income Capitalization Approach:

[d] Approach through which an appraiser derives a value indication for income-producing property by converting anticipated benefits, i.e., cash flows and reversions, into property value. This conversion can be accomplished in two ways: one year's income expectancy or an annual average of several years' income expectancies may be capitalized at a market-derived capitalization rate or a capitalization rate that reflects a specified income pattern, return on investment, and change in the value of the investment; secondly, the annual cash flows may be discounted for the holding period and the reversion at a specified yield rate.

Insurance:

[w] A system of protection against loss in which a number of individuals agree to pay certain sums periodically for a guarantee that they will be compensated under stipulated conditions for any specified loss by fire, accident, death, etc.

[b] A contract whereby, for a stipulated consideration, one party undertakes to compensate the other for loss on a specified subject by specified perils.

Intangible:

[w] That which represents value but has either no intrinsic value or no material being.

[a] (Assets) — Items of property, such as franchises, trademarks, patents, copyrights, and goodwill; also such deferred items as development or organization expenses.

(Value) — A value not imputable to any part of the physical property such as the excess value attributable to a favorable lease, or the value attributable to goodwill.

[b] (Property) — Used chiefly in the law of taxation, this term means such property as has no intrinsic and marketable value, but is merely the representative or evidence of value, such as certificates of stock, bonds, promissory notes, and franchises.

Invested Capital:

[a] The sum of the debt and equity in an enterprise on a long-term basis.

Majority:

[a] Ownership position greater than 50% of the voting interest in an enterprise.

Majority Control:

[a] The degree of control provided by a majority position.

Market:

[w] Opportunity to sell, demand, buy, or supply; a region in which goods can be bought and sold.

[b] Place of commercial activity in which articles are bought and sold.

Marketability Discount:

[a] An amount or percentage deducted from an equity interest to reflect lack of marketability.

Minority Discount:

[a] The reduction, from the pro rata share of the value of the entire business, to reflect the absence of the power of control.

Minority Interest:

[a] Ownership position less than 50% of the voting interest in an enterprise.

Net Assets:

[a] Total assets less total liabilities.

Net Income:

Revenues less expenses, including taxes.

Patent:

[w] Open to examination by the public, said of a document granting some right or rights, as to land, a franchise, an office, or now especially, an invention.

[b]	A grant of some privilege, property, or authority, made by the government or sovereign of a country to one or more individuals.

Rate of Return:

[a]	An amount of income realized or expected on an investment, expressed as a percentage of that investment.

Referral:

[w]	A referring or being referred, as for professional service, etc.; a person who is directed to another person, agency, etc.

Replacement Cost New:

[a]	The current cost of a similar new item having the nearest equivalent utility as the item being appraised.

Reproduction Cost New:

[a]	The current cost of an identical new item.

Software:

[w]	The programs, routines, etc., for a computer; the program material, as a film on videocassette, that is used with electronic equipment.

Subscription:

[w]	A formal agreement to receive and pay for periodicals, books, or other services for a period of time.

[b]	The act of writing one's name under a written instrument; a written contract by which one engages to take and pay for capital stock of a corporation, or to **contribute a sum of money for a designated purpose, either** gratuitously, as in the case of subscribing to a charity, or in consideration of an equivalent to be rendered, as a subscription to a periodical, etc.

Trade Name:

[w]	The name by which a commodity is commonly known in trade; the name under which a company carries on business.

[b]	A name used in trade to designate a particular business of certain individuals considered somewhat as an entity or the place at which a business is located, or of a class of goods, but which is not a technical trademark either because not applied or affixed to goods sent into the

market or because not capable of exclusive appropriation by anyone as a trademark.

Trademark:

[w] A symbol, design, work, letter, etc. used by a manufacturer or dealer to distinguish a product or products from those of competitors; usually registered and protected by law.

[b] A distinctive mark, motto, device, or emblem, which a manufacturer stamps, prints, or otherwise affixed to the goods he produces, so that they may be identified in the market, and their original be vouched for.

Turnkey:

[w] Designating, of, or by a method of construction, installation, etc., whereby the contractor, installer, etc. assumes total responsibility from design through completion of the project.

Valuation:

See Appraisal.

Workforce:

[w] The total number of workers actively employed in, or available for work, in a nation, region, plant, etc.

Working Capital:

[a] The amount by which current assets exceed current liabilities.

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[i] IRM 8131(2)
[ii] Treas. Reg. § 1.170A-1(c)(2)
[iii] Anselmo v. Commissioner, 757 F.2d 1208, 85-1 U.S.T.C. 9335, (11th Cir. 1985), aff'g 80 T.C. 872
[iv] Rev. Rul. 68-609, 1968 C.B. 327
[v] Rev. Rul. 59-60, 1959-1 C.B. 237
[vi] Morris v. Commissioner, 761 F.2d 1195, 85-1 U.S.T.C. 13,617 (6th Cir. 1985)
[vii] United States v. Simmons, 346 F.2d 213, 65-2 U.S.T.C. 12,321 (5th Cir. 1965), 63-2 U.S.T.C. 12,176; Estate of Bright v. United States, 658 F.2d 999, 81-2 U.S.T.C. 13,436 (5th Cir. 1981), 80-2 U.S.T.C. 13,359, 619 F.2d 407
[viii] John M. Moore, T.C. Memo 1991-546
[ix] Ithaca Trust v. United States, 279 U.S. 151, 1 U.S.T.C. 386 (1929) rev'g 64 Ct. Cl. 686; Estate of Jephson v.
Commissioner, 81 T.C. 999 (1983); Cowyers v. Commissioner, 11 B.T.A. 1040 (1928).
[x] Powers v. Commissioner, 312 U.S. 259, 41-1 U.S.T.C. 492 (1941), L.B. Maytag v. Commissioner, 187 F.2d 962, 51-1 U.S.T.C. 683 (10th Cir. 1951)
[xi] Rev. Proc. 79-24, 1979-1 C.B. 565

[xii] Shannon P. Pratt, *Valuing a Business, The Analysis and Appraisal of Closely Held Companies* (3rd Ed. 1995).
[xiii] Rev. Proc. 66-49, 1966-2, C.B. 1257.
[xiv] Rev. Rul. 59-60, 1959-1 C.B. 287
[xv] Rev. Rul. 65-193, 1965-1 C.B. 370
[xvi] Rev. Rul. 77-287, 1977-2 C.B. 319 and Rev. Rul. 83-120, 1983-2 C.B. 170
[xvii] Tully Estate v. Commissioner, 78-1 U.S.T.C. 13,228 (Ct. Cl. 1978); Central Trust Company v. United States, 305 F.2d 393, 62-2 U.S.T.C. 12,092 (Ct. Cl. 1962)
[xviii] Forbes v. Hasset, 124 F.2d 925, 42-1 U.S.T.C. 10,127 (1st Cir. 1942)
[xix] Hayes Estate v. Commissioner, 32 T.C. M. 1102 (1973). T.C. Memo 1973-236
[xx] Rothgery v. United States, 475 F.2d 591, 73-1 U.S.T.C. 12,911 (Ct. Cl. 1973); Huntington Estate v. Commissioner, 94 F.2d 1019, (9th Cir.), 36 B.T.A. 698 (1937), acq. 1938-1 C.B. 15
[xxi] McKee v. Commissioner, 116 F.2d 499 (6th Cir. 1940), 41-1 U.S.T.C. 9154, Affg 37 B.T.A. 1135, 1939-1 C.B. 3
[xxii] Hunt Estate v. Commissioner, 11 T.C. 984 (1948), 1949-1 C.B. 2
[xxiii] Vandenhoeck Estate v. Commissioner, 4 T.C. 125 (1944), 1944 C.B. 29
[xxiv] Adams Estate v. Henslee, (74 F. Supp. 106) 47-2 U.S.T.C. 10,577 (D.C. Tenn. 1947).
[xxv] Sirloin Stockade, Inc. v. Commissioner, 40 T.C.M. 928 (1980), T.C. Memo 1980-308
[xxvi] Rev. Rul. 59-60, 1959-1 C.B. 237. See also Rev. Rul. 65-193, 1965-2 C.B. 370, Rev. Rul. 68-609, 1968-2 C.B. 327, Rev. Rul. 77-287, 77-2 C.B. 319, Rev. Rul. 80-213, 80-2 C.B. 101, and Rev. Rul. 83-120, 83-2 C.B. 170.
[xxvii] Estate of Andrews v. Commissioner, 79 T.C. 938 (1979)
[xxviii] Estate of Bright v. United States, 81-2 U.S.T.C. 13,436 (5th Cir. 1981)
[xxix] Popstra, 680 F.2d 1248, 82-2 U.S.T.C. 13,475
[xxx] Minahan, 88 T.C. 492 (1988)
[xxxi] Rev. Rul. 93-12, 1993-7 IRB 13
[xxxii] Central Trust Co. v. United States, 305 F.2d 292 (Ct. Cl., 1962), 62-2 U.S.T.C. 12, 092.
[xxxiii] See also, Dougherty, 59 T.C.M. 772, Dec. 46622(M) and Jephson, 87 T.C. 297 (1986)
[xxxiv] Berg, 61 T.C.M. 2949 (1991); 976 F.2d 1163 (8th Cir, 1992)
[xxxv] Estate of Piper, 72 T.C. 1062; Estate of Cruikshank, 9 T.C. 162; Estate of Robinson, 69 T.C. 222
[xxxvi] General Utilities and Operating Co. v. Helvering, 296 U.S. 200 (1935)
[xxxvii]

Price	$2,200,000	$2,200,000
Tax	560,000	1,049,600
Net	$1,640,000	$1,150,400

Proceeds to Shareholder: Price	$2,200,000
Less Corp. Tax	(680,000)
Proceeds	$1,520,000

[xxxviii] See Estate of Beschoff, 69 T.C. 32; Estate of Obering, T.C. Memo 1984-407; Estate of Davis, T.C. Memo 1978-69; Estate of Littick, 31 T.C. 181; Estate of Bensel, 36 B.T.A. 246; Aff'd 100 F.2d 639
[xxxix] Krauss v. United States, 140 F.2d 510; Sames, 3 T.C. 1260; Moore, 3 T.C. 1205; Spitzer, 153 F.2d 967; Commissioner v McCann, 146 F.2d 385
[xl] Rev. Rul. 77-287, 1977-2 C.B. 319
[xli] IRC § 2031
[xlii] Estate of Piper, 72 T.C. 1055 (1979), Estate of Cruickshank, 9 T.C. 162
[xliii] Estate of Piper, 72 T.C. 1055 (1979)
[xliv] Rev. Rul. 83-120, 1983-2 C.B. 170
[xlv] Newhouse Estate v. Commissioner, 94 T.C. 193 (1990)
[xlvi] Newark Morning Ledger, 113 SC 1670 (1993)
[xlvii] Citizens and Southern Corp., 91 T.C. 463 (1988).
[xlviii] Business Service Industries, Inc., T.C.M. 1986-86.
[xlix] See *Corporate Valuation*, Gordon V. Smith (John Wiley & Sons, 1988).

[1] Ithaca Industries, Inc. v. Commissioner of Internal Revenue, 17 F.3d 684 (4th Cir. 1994), aff'g 97 T.C. 253 (1991).