VALUATION OF CLOSELY HELD STOCK

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Abstract

Valuation of closely held corporate stock may rest upon several methodologies: restrictive agreements, earning capacity, dividend paying capacity, book or net asset value, goodwill and other intangible assets, as well as minority and controlling interests. Rev. Rul. 59-60 provides guidelines for valuation in the event of few or no market quotations and no restrictive agreements. Various cases have focused on critical factors in the valuation process with little guidance from the courts as to weight or value of such factors.

Introduction

Knowing and documenting the value of a closely held corporation is critical for federal income tax as well as estate and gift tax purposes. Further, in the event of divorce, an equitable division of the property is paramount to a fair and amicable termination of the marital relationship. Insurance coverage is more efficiently purchased with adequate knowledge of the value of the underlying business. The opportunist-oriented tax professional can focus his attention on the issues of valuation and development of his expertise in litigation support as well as tax planning. This article discusses the various approaches to valuation of a closely held corporation through analysis of various documents from the Service as well as pertinent cases. Specifically, the author addresses six valuation methodologies as follows:

1. Restrictive agreement
2. Earning capacity
3. Dividend paying capacity
4. Book or net asset value
5. Goodwill and other intangible assets
6. Minority and controlling interests

The difficulty in valuation of a closely held corporation rests upon the lack of an established market for the stock, few shareholders, and little

trading.¹ Fair market value, defined in the Regulations,² is not to be determined by a forced sale price or the price of the item in a market other than one in which the item is commonly sold to the public. The determination of fair market value of closely held stock places the burden of proof on the taxpayer. In Dellinger,³ the court ruled against the taxpayer because of failure to prove the Service incorrect in its valuation. Valuation of closely held stock for estate, gift and income tax purposes, as well as divorce and insurance, is difficult and requires careful documentation and attention to the rules.

Internal Revenue Service Perspective

Rev. Rul. 59-60 provides guidelines for valuation when market quotations are lacking or too scarce to be recognized and no restrictive agreement exists. All available financial data and all relevant factors affecting the fair market value should be considered, including the following:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.

3. The book value of the stock and the financial condition of the business.
4. The earning capacity for the company.
5. The dividend paying capacity.
6. Whether the enterprise has goodwill or other intangible value.⁴

Valuation is not an exact science, but it does require objectivity, common sense, informed judgment of relevant facts, and reasonableness when weighing all facts and their significance.⁵

Restrictive Agreements

Agreements restricting the transfer of highly speculative stock can cause those shares to have no market value when received for income tax purposes.⁶ The professional should read the articles of incorporation, by-laws, and agreements between shareholders to determine if a restrictive agreement exists.

An option or buy-sell agreement must be definite in its terms if it is to restrict the value of the stock at a specified amount.⁷ It should set the fair market value of the stock and restrict inter vivos dispositions as well as disposition upon death. The option price, at which a corporation may repurchase the stock before it can be otherwise disposed of by a stockholder through a sale or other transfer, will be accepted as fair market value at date of death. The legality of such agreement rests with local law. In Bowers,⁸ the court determined that an option contract giving stockholders a right to purchase at a specified price, upon the owner's sale or death, limited the value of the stock to the low price at which he or his executors were obliged to sell it. In the McCann⁹ case, the court determined that no market for the stock existed except the one created in the corporate by-laws. These agreements were written in a manner that allowed the value of the closely held stock to be determined on the basis of the amount specified in the agreement. If a restrictive agreement exists, it must meet the ruling guidelines to prevail in a valuation proceeding. Some thoughts to keep in mind when

analyzing the strength of restrictive agreements include the following:

1. Read articles of incorporation, by-laws, and agreements between shareholders.
2. Is option or agreement definite in its terms?
3. What is the option price?
4. Is the fair market value determined by the amount specified in the agreement?

Earning Capacity

Earning capacity is an estimate of an approximate worth of a corporation including intangibles, i.e., goodwill. Determination of the earning capacity is important in the valuation process as it provides an estimate of the future earning power of the corporation. Earning capacity gives an overall value for the entire corporation.¹⁰

You may want to consider earnings of utmost importance when valuing stock of companies which sell products or services; however, in the investment or holding type of company, you may give the greatest weight to the assets underlying the security itself. Past earnings (5-10 year averages) are the best guide for determining earning capacity; but current and forecasted trends should be used as a guideline to produce a more realistic valuation. Greater weight may be given to trends and their expected result on recent earning, rather than simply averaging earnings. In Central Trust Co.¹¹ the court ruled that past earnings are significant only insofar as they reasonably forecast future earnings. The only basis for such a forecast is the company's normal operation, which will not recur.

There is not a simple solution for finding the precise rate of return or dividend yield for stock valuation, even for a widely held stock listed on the New York Exchange. Wide variations occur across industries, years, and economic conditions. Important factors to consider in formulating a capitalization rate are the nature of the business, the risk involved, and the stability or irregularity¹² of past earnings and share prices.

A comparison of publicly traded companies presumes that their lines of business be the same or similar. Consideration may be given to other relevant factors so that a value comparison may be obtained. Obviously, the issue here is in determination of comparable companies. In Central Trust Co., the court rejected American and Continental Can companies as comparable because of size and position in the industry. The court looked at smaller companies for guidelines in determining a capitalization rate. In Clarke,¹³ the court rejected the companies selected as comparable because, although they were in the aviation industry, there were considerable differences in marketing, management, earnings, dividend payout capacity, book value and position in the industry.¹⁴

The courts have continued to be unsettled in their selection of criteria for evaluation of comparable firms. In Wallace,¹⁵ the price earnings ratio was rejected because it ignored all economic conditions of area at the time which made the stock more valuable than the appraiser had determined when using comparable companies. In the Blass case¹⁶, the court rejected the choice of comparable companies because there was no reliable evidence presented to convince the court that the companies were comparable. They relied on Sec. 3.01 and 4.01 of Rev. Rul. 59-60 to determine the value. The court determined valuation on earning capacity, risk, capitalization of earnings, sales figures, and analyses of price earnings ratios. Not disclosed is the weight given to each factor nor the methodology used to determine the value of each factor. Just the task of finding comparable companies is difficult enough because the service or the courts disagree with the experts' determination of comparability. Methodologies and weights for averaging the various components reflect the courts' vague decision-making process.

Dividend Paying Capacity

Since closely held corporations frequently do not pay dividends, the dividend paying capacity is the appropriate criteria for stock valuation. When you have an actual or effective controlling interest

in a corporation that is to be valued, the dividend factor is not a material element. The reason it is not is because such dividends are discretionary with the controlling stockholders. Dividend paying capacity is a factor that should be considered in an appraisal, but dividends paid are not a function of corporate capacity to do so.¹⁷ There may be other more important factors, such as keeping a reasonable portion of profits to meet competition, expansion, or diversification. The valuation of dividends is similar to the process of determining earnings capacity. A projected dividend rate is found and multiplied by the reciprocal of the capitalization rate to produce a value. If the dividends paid don't reflect the dividend paying capacity, then past dividends cannot be used as a surrogate. There are two choices that can be made: disregard dividends in arriving at a valuation or hypothesize a reasonable dividend based on projected future earnings plus the need to retain earnings in the business.

Determining the correct dividend capitalization rate is as difficult as determining the earnings capitalization rate. In Clair Trust Co.,¹⁸ the court rejected the taxpayer's assertion that an investor would require at least a 7 percent yield before investing. The court determined that 3.5 percent was the rate paid by comparable companies, an arbitrary determination with little or no explanation as to how the rate was determined.

Book Or Net Asset Value

The value of a closely held corporation with massive investment or real estate holdings is dependent upon the fair market value of the assets underlying the stock. Earnings and dividend paying capacity are inappropriate to these types of companies.¹⁹ Operating companies, to the contrary, have assets booked at historical cost whose book value per share bears little relation to fair market value of each share. Net asset or book value will not be as heavily weighted in operating companies as in investment or real estate holding companies. As a last resort, the courts may look to net asset value of operating companies.

Investment company valuation has incorporated discounts for a variety of items, including minority interests not having the ability to force liquidation, lack of marketability, unregistered stock, and liquidation costs. The court in Jephson²⁰ determined that a discount for nonmarketability was unwarranted because it ignored the fact that complete ownership of each corporation enabled the petitioner to obtain direct ownership of assets through partial or complete liquidation or dividend in kind. The court also disallowed a valuation based on comparison to closed end investment companies.

Corporate ownership of life insurance on the principal shareholders is another factor when determining net asset value. Nonoperating assets, including life insurance payable to or for the benefit of the company, must be considered when determining net asset value of a corporation.²¹

Goodwill And Other Intangible Assets

The determination of earnings capacity includes the valuation of goodwill and other intangibles which requires that they not be valued separately.²² A formula approach for determining the fair market value of intangible assets may be utilized:

*A percentage return on the average annual value of tangible assets used in a business is determined using a period of years. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount or the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of say 15 to 20 percent, is the value of the intangible assets of the business.*²³

This approach should be used only if there is no better basis available.

Minority And Controlling Interests

After the valuation of the closely held corporation, it must be determined whether a minority or controlling interest is at stake. If a minority interest, a minority discount is allowed because minority shareholders do not have the power to liquidate the corporation which makes the stock substantially less valuable than that of controlling shareholders. Within a family context, a minority discount meets with opposition from the service:

*ordinarily no minority interest discount will be allowed with respect to transfers of shares of stock among family members where, at the time of the transfer, control (either majority voting control or de facto control) of the corporation exists in the family, . . . However, when there is evidence of family discord or other factors indicating that the family would not act as a unit in controlling the corporation, a minority interest discount may be allowed.*²⁴

The courts disagree and allow for a discount for minority interests. In Cravens²⁵, the court stated that minority interests in a closed corporation are usually worth much less than the proportionate share of the assets to which they attach.

In valuing a controlling interest, a premium is often added to the value of the stock. The size of the block of stock may be a relevant factor to be considered. Although a minority interest in unlisted corporate stock is more difficult to sell than a similar block in a listed corporation, the large block of stock may represent an added element of value, thus justifying a higher price.²⁶ The court stated in Salsbury²⁷ that a premium for control is expressed as the percentage by which the amount paid exceeds the amount which would have otherwise been paid for the shares if sold as minority interests and is not based on a percentage of the value of the stock held by all or a particular class of minority shareholders. This premium is for the control which the shareholder had in determining the direction of the corporate assets. The court also stated that it is difficult to determine what an outsider might pay for the

authority inherent in a controlling interest. In this case, a 38.1 percent control premium was determined based on an expert's research of the premium being paid for controlling interests in takeovers and mergers which were occurring in considerable number in 1967, the year of the decedent's death.

Minority and controlling interests do not provide the valuation problems that other areas do. If either is a question in the process of valuation, it must be dealt with by providing the same accurate research and documentation as other areas have required.

Conclusion

Valuation of a closely held corporation is a difficult task requiring diligent research and voluminous documentation. If the matter goes to court, the expert must present accurate evidence

and documentation to support the conclusions reached. The burden of proof is on the taxpayer which requires that there be a preponderance of evidence on the taxpayer's part concerning the valuation his expert has reached. In recent years the courts have made several statements concerning valuation and its need to be determined outside of the courts. The better time to document is far in advance of litigation.

In Buffalo Tool and Die²⁸, the courts indicated that the valuation issue is capable of resolution by the parties themselves through an agreement which will select a compromise, saving the expenditure of time, effort, and money by the parties and the court. This sentiment was restated by the court in Sirloin Stockade²⁹. In neither instance did the court use a middle of the road determination, but chose one side's valuation as correct and the other as incorrect.

Endnotes

1. Rev. Rul. 59-60, 1959-1 C.B. 37.
2. Rev. Reg. 20.2031-1(b).
3. *Lester E. and Anne F. Dellinger*, 32 T.C. 1178 (1959).
4. Rev. Rul. 59-60, 1959-1 C.B. 37.
5. Rev. Rul. 59-60, 1959-1 C.B. 37, Sec. 3.01.
6. *Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481 (1937), 18 AFTR 1174.
7. Rev. Rul. 65-76, 1954-1 C.B. 194.
8. *Wilson v. Bowers*, 57 F. 2d 682 (2nd Cir., 1932), 11 AFTR 33.
9. *Harrison v. McCann*, T.C. 702 (1943).
10. Rev. Rul. 59-60, 1959-1 C.B. 37, Sec. 5a.
11. *Central Trust Co. v. U.S.*, 305 F. 2d 393 (Ct. Cl., 1962), 10 AFTR 2d 6203.
12. Rev. Rul. 59-60, 1959-1 C.B. 37, Sec. 6.
13. *Estate of Clarke*, Par. 76,382 P-H Memo TC (1976).
14. Rev. Reg. 20.2031-2(f).
15. *Marvin Wallace v. U.S.*, (DC W. Va., 1973), 31 AFTR 2d 73-1395.
16. *Noland Blass, Sr. v. U.S.*, 344 F.Supp. 669 (DC Ark., 1972), 19 AFTR 2d 72-1252.
17. Rev. Rul. 59-60, 1959-1 C.B. 37, Sec. 4.02(e).
18. *Clair Trust Co. v. U.S.*, 305 F. 2d 393 (Ct. Cl., 1962), 10 AFTR 2d 6203.
19. Rev. Rul. 59-60, 1959-1 C.B. 37, Sec. 5(b).
20. *Estate of Lucretia Davis Jephson*, 87 T.C. 297.
21. Rev. Reg. 20.2031-2(f).
22. Rev. Rul. 59-60, 1959-1 C.B. 37, Sec. 4.02(f).
23. Rev. Rul. 68-609, 1968-2 C.B. 327.
24. Rev. Rul. 81-253, 1981-2 C.B. 187.
25. *Cravens v. Welch*, 10 F. Supp. 94 (DC Cal., 1935), 15 AFTR 452.
26. Rev. Rul. 59-60, 1959-1 C.B. 237, Sec. 4.02(g).
27. *Estate of Joseph Salisbury*, Par. 75,333 P-H Memo TC (1975).
28. *Buffalo Tool and Die Mfg. Co., Inc.*, 74 T.C. 441 (1980).
29. *Sirloin Stockade*, Par. 80,303 P-H Memo TC (1980).