An Estate Planner's Guide to Revenue Ruling 59-60

Understand How Valuation Experts Utilize the Ruling in Income and Estate & Gift Tax Valuation Engagements

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MERCER CAPITAL

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Preface

Tagging a text with the label "classic" should not be done carelessly. But over 50 years after its initial release, few would disagree that Revenue Ruling 59-60 deserves the title. Written in the spare, unadorned style of a government publication, the Ruling is a compact storehouse of enduring practical wisdom for business appraisers and attorneys who are users of appraisal reports.

Our purpose in writing this book is twofold: first, to offer a guided tour through the Ruling, pointing out some of the most prominent features of the landscape (and providing the occasional warning about rough terrain); second, to pull back the curtain a bit, granting a non-technical view for estate planner's of how appraisers (at least this group) attempt to translate the guidance found in the Ruling into actual valuation engagements.

Having been actively appraising privately held businesses for over 25 of the 50+ years since the Ruling's issuance, we find ourselves often returning to the Ruling, whether for guidance in novel situations or simply to confirm some intuition. In short, it is a trusted companion.

As we describe the contents of this book, be aware that it is our intention that each chapter, while part of a larger whole, stand alone. Therefore, for those of you who are reading through the book in an orderly fashion, you will notice some redundancy. However, when referencing individual chapters, their completeness should prove helpful.

» In Chapter 1, we walk through the various sections of the Ruling, summarizing what we find important, helpful, extraneous, and occasionally frustrating as appraisers.

» A well-crafted business appraisal tells a story. A key element of any story is its setting. The stories appraisers tell when preparing valuations under Revenue Ruling 59-60 are set in the land of fair market value. In Chapter 2, we unpack the definition of fair market value and discuss its implications for making and evaluating valuation judgments.

» Chapter 3 describes some of the primary challenges in applying the Ruling to the valuation of operating companies. We discuss some of the practical challenges faced, and judgments made, by appraisers when valuing operating companies.

» We turn our attention in Chapter 4 to asset-holding entities, reviewing some of the most common valuation methods and techniques used to value limited liability companies, family limited partnerships, and other businesses that exist primarily to hold assets rather than sell a product or service.

» In Chapter 5, we consider the role of intangible assets in the value of a business. Despite being written in a day when a far greater portion of business value was attributable to tangible assets, Revenue Ruling 59-60 is prescient with respect to the contribution of intangible assets to the value of a business.

» Chapter 6 offers advice for estate planners who find themselves in need of a business appraiser.

» Our good friend Paul Hood takes the reins in Chapter 7, providing an exhaustive overview of some of the landmark court cases related to the Ruling. Paul is a successful and well-respected estate planning attorney, and we are grateful for his incisive and informative commentary.

» Two appendices close out the book. The first simply reproduces the text of Revenue Ruling 59-60 in its entirety, and the second is a bibliography of pertinent court cases.

We trust you will enjoy this short tour through Revenue Ruling 59-60 and find the guidance in the book helpful as you review valuation reports. We have been referring to, questioning, interpreting, and relying on the Ruling's insights and guidance for over 25 years, and we anticipate continuing to benefit from the practical wisdom found in it for years to come.

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While the entire staff of Mercer Capital contributed to this book in some form or fashion, the following professionals provided the bulk of the content.

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Chapter 1
A Summary of Revenue Ruling 59-60 from a Business Appraiser's Perspective

INTRODUCTION

Promulgated for gift and estate tax compliance, Revenue Ruling 59-60 ("Rev. Rul. 59-60" or "the Ruling") provides valuation guidance regarding the valuation of the common stock of closely held companies, and companies where market quotations either "are not available" or "are of such scarcity that they do not reflect the fair market value."

In this chapter, we provide a guided tour through each section of Rev. Rul. 59-60 from the perspective of a practicing business appraiser. We have been valuing private companies of all sizes in almost every conceivable industry in light of the Ruling for over 25 years. Along the way, we comment on the enduring wisdom found in the Ruling, as well as some of the practical considerations and challenges of implementing the guidance when faced with the unique facts and circumstances of actual business appraisals.

SECTION 1. PURPOSE

The language of Section 1 suggests that if market quotations occur in sufficient volume, they may reflect fair market value. There is little guidance on what constitutes "sufficient volume" to reflect fair market value for a quoted security, so there is often a need or requirement for independent appraisal to facilitate gifting or other transactions involving the securities of nominally "public" companies where shares may be quite illiquid. The requirement for valuing shares of non-public or privately owned entities is apparent.

SECTION 2. BACKGROUND AND DEFINITIONS

Valuation conclusions are meaningless if not anchored to a particular date. This "as of" date establishes the base of information with respect to the subject company, industry, economy, and market conditions that are relevant to the valuation conclusion. For estate tax purposes, appraisals must have a valuation date of either the date of the decedent's death or the alternate valuation date, which is six months after the date of death.

Just as valuation conclusions are specific to a particular date, they are also a function of the relevant definition of value. In Section 2, the Ruling adopts the definition of fair market value set forth in the respective estate and gift tax regulations: ". . . 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." Additional guidance from court decisions regarding other characteristics of the hypothetical buyer and seller is also cited. We provide a comprehensive discussion of the definition of fair market value in Chapter 2.

In Section 2.03, the IRS declares its suspicions regarding the use of "market transactions" evidence derived from intra-family transfers of interests in family businesses. The suspicion arises because of the potential advantages accruing to the taxpayer if artificially low transaction values are considered in an estate tax or gift appraisal. Appraisers placing considerable weight on market transactions need to carefully consider whether such transactions actually occurred at arm's length.

SECTION 3. APPROACH TO VALUATION

In Section 3, the Ruling offers what is effectively a philosophy of valuation. Since, as is commonly accepted, valuation is not an exact science; a sound business appraisal must address the unique facts and circumstances of each case. Given the abundant variations of facts and circumstances one is likely to encounter, formula appraisals are justly viewed with suspicion. Further, Rev. Rul. 59-60 states that while appraisal is a fact-based endeavor, the elements of common sense, informed judgment, and reasonableness are essential in weighing the significance of the facts. Both IRS agents and appraisers too often overlook these "critical three factors" when making significant valuation judgments.

Section 3.02 notes that, other things being equal, a company is worth more when the economy is strong than when it is weak. The same logic applies to local or regional economic conditions for companies like banks, construction and related businesses, retail-oriented businesses, and others, where local economic conditions strongly influence sales and earnings. What's more, financing is generally more available in the midst of a strong economy, which can increase a company's value.

The Ruling also highlights the negative relationship between uncertainty and value. When assessing risks and their effect on value, appraisers must consider the relevant facts and circumstances as of the valuation date. Risks that become apparent only after the valuation date are not relevant, while risks that are resolved (positively or negatively) subsequent to the valuation date are relevant.

The first sentence of Section 3.03 casts the appraiser in the role of prophet. The Ruling suggests that the resulting prophecies be "based upon facts available at the required date of appraisal." Since most tax-related appraisals are "historical" before they are scrutinized, the parties generally know how the prophecy fared against subsequent performance. There is a very real temptation to look forward from an historical appraisal to validate or condemn the valuation prophecy, depending upon which side of the argument one may be representing.

The remainder of Section 3.03 has been the root of a myriad of problems for appraisers and IRS agents. The logic of Section 3.03 goes like this:

- » The stock prices of public companies provide a consensus outlook and valuation for the underlying companies.
- » Unfortunately, we do not have this kind of direct valuation evidence for private companies.

» Therefore, the "next best measure" for valuation evidence may come from "companies engaged in the same or a similar line of business" whose shares "are selling in a free and open market."

While this logic is compelling, too many appraisers and IRS agents have interpreted it to mean that every private company should be valued at the average or median valuation multiple of the public companies deemed to be "similar" or comparable.

Similar public companies can provide relevant market evidence in the valuation of private businesses. However, when public companies are used to provide valuation evidence for private companies, the appraiser must diligently compare the risks of the private company to those of guideline public companies, which tend to be larger, more diversified, and as a result, more stable. This analysis can be implemented in a variety of ways, ranging from adjusting the observed valuation multiples of the public companies to applying different weight to the various indications of value.

SECTION 4. FACTORS TO CONSIDER

Section 4.01 enumerates factors that should be considered in the valuation of closely held companies. Consideration of these factors makes so much sense that they are known as the "basic eight factors" (or the "basic eight") of valuation and are recited in virtually every business appraisal.

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.

Section 4.02 presents an elaboration of each of the basic eight factors. In the discussion below, we walk through each of the basic eight factors, providing brief commentary from a business appraisal perspective.

a) The historical performance of a business sheds light on its outlook and degree of risk. Rev. Rul. 59-60 mandates a thorough analysis of the subject company's historical financial performance and operations. Historical performance is the wellspring from which future performance flows, indicating the likely direction and velocity of future performance. From this source, the appraiser must make reasonable judgments regarding if, how, and why future performance will differ from the past.

   When available, detailed financial and operating data should be reviewed and analyzed for at least four to six years preceding the valuation date. For cyclical businesses, it may be appropriate to review sales, earnings, margins, and returns over an even longer period to understand the nature of the business and its current location in the business cycle. For other companies, the most recent results and financial conditions may provide the best insight into the future. Regardless of the company, the analyst must study the current situation closely while mining the historical results for valuable pieces of context and perspective.

   Appraisers need to understand the significant changes reflected in the subject company's historical financial statements and why they occurred. Events that happened in the past but are deemed unlikely to happen again are called non-recurring events. Assessing these events requires more judgment than one might first suspect. While the items categorized as "extraordinary" by a company's accounting firm are frequently non-recurring, a multitude of other events may also qualify. On the other hand, the life of a business is filled with many events that, if considered in isolation, appear to be non-recurring, but in the context of actual operations over time, actually occur with some regularity. Appraiser judgment is critical in the determination of non-recurring events and their impact on the outlook for future earnings.

b) The Ruling advocates an examination of economic conditions and outlook as of the date of the appraisal. Appraisers should consider the national economy, specifically the economic factors (the interest rate environment, housing starts, consumer confidence, and the like) that most directly influence the subject company's performance. Local and regional economic conditions are often of particular significance. Finally, it is important to understand the general condition and outlook for the industry or industries within which a subject company operates.

   Where data is reasonably available, appraisers should attempt to compare the subject company's performance with that of industry peers. RMA data, which covers about four hundred industry groups, is a commonly cited general source for such comparisons. Other industry-specific data is also available for many industries through trade associations or other targeted data sources. Appraisers should not forget, however, that performance comparisons with aggregate industry peer data may be less relevant if valuation indications are based upon comparisons with a specific group of public companies. In that event, the appraiser should compare the subject company's performance and financial position to that of the selected public companies.

   Appraisers should analyze not only the subject company's position within the industry, but also the industry's position within the economy. Is the industry declining or prospering? The subject company may be the dominant company in the cast iron skillet manufacturing industry, but other forms of cookware (stainless steel, copper, etc.) and other means of cooking (microwave and eating out) may mitigate the significance of this industry dominance.

Appraisers ignore the subject company's competition, actual and prospective, at their own peril. High profit margins tend to attract competition, which can dampen the growth outlook for established businesses in an industry. Is the overall market growing fast enough for the established business to sustain reasonable growth? Are valuable trade secrets becoming known? Is the company in a fad or fashion industry? These can be important questions for the business appraiser's consideration.

Within a particular industry group, it can be important to look at the outlook for specific competitors within the industry. Industry pricing trends and the investment returns of companies in the subject industry are likely to influence value. Reasonableness, common sense, and informed judgment must be brought to bear on each of these judgments.

So-called key person dependencies reflect a founder or other key employee's unique influence on sales, marketing, product development, or other managerial tasks. If a key person retains all decision-making authority, subordinate managers will not develop and gain the confidence and experience necessary to reduce key person issues over time. Companies with significant key person dependencies are more risky, and therefore, less valuable than if a well-developed management team were in place. While there is little or no empirical data to support such direct discounts, some court cases have allowed specific "key man" discounts in valuation. Key person dependencies, like other risks, are probably best considered in the overall capitalization rate applied to earnings or in the weight applied to different valuation indications. Appraisers should clearly identify and address key person dependencies if any exist.

c) Sometimes appraisers look at several years of income statements, but only a current balance sheet. This can be dangerous as balance sheet trends can reveal important clues about the future performance of the business. Appraisers should carefully adjust interim balance sheets (and income statements) to be consistent with the audited or other year-end financial statements. Such differences, which may be the result of annual accruals of depreciation, insurance, management bonuses or taxes, or other factors, need to be identified to develop reasonable valuation conclusions.

Careful reading of the notes to audited, reviewed, or compiled financial statements often reveals facts and circumstances that can influence value. Such data should be summarized in the financial schedules or discussed specifically in the text of an appraisal report. Unfortunately, many appraisers do not present the detail called for by Rev. Rul. 59-60 in their appraisals.

The Ruling mentions a few examples of balance sheet ratios that may yield valuation insight regarding the subject company. Appraisers should assess these and other standard analytical ratios when reviewing the subject company's financial position. Appraisers should be discriminating when evaluating the relevance of the data revealed by the level, and trend, of the various balance sheet ratios to the value of the subject company.

The Ruling singles out non-operating assets for specific treatment. Non-operating assets include excess assets such as cash held beyond ordinary operating requirements, land held for investment purposes, common stock, and other investments not directly related to the operation of a business. Appraisers should be careful to consider whether the income statement needs adjustment for income or expense items related to non-operating or excess assets. Once identified, the book value of such assets should be adjusted to reflect fair market value as of the valuation date.

Appraisers should also carefully consider whether the book value of operating assets such as real estate, inventories, accounts receivable, or machinery and equipment should be adjusted to current fair market value. The subject company may also report liabilities for which the book value should be adjusted to fair market value.

Rev. Rul. 59-60 fails to address the issue of embedded tax liabilities (or benefits) that would be triggered if the company were to realize the current fair market value of its assets. Embedded tax liabilities (or benefits) can influence the value of the subject company. For example, the sale of appreciated assets may trigger adverse tax consequences, which would tend to reduce value. The IRS has sometimes argued that since such tax consequences may not ever be realized, they should be ignored, though several recent decisions seem to indicate this view is falling out of favor with appellate courts, which have reversed the Tax Court on this issue. In the context of determining fair market value, appraisers should directly and unambiguously address the issue of embedded taxes. The facts and circumstances of a particular situation, or the weightings applied to various valuation indications, may temper the effect of such tax issues on the ultimate conclusion of value. Nevertheless, these issues should not be ignored, particularly if the appraiser believes that the current values of balance sheet items differ materially from their book values.

Balance sheet analysis can also reveal information about the acquisition of production facilities. In combination with a review of revenues, earnings, and cash flows, balance sheet analysis may suggest an imminent need for additional investment in fixed assets. The point is that the analyst must analyze the balance sheet (and related financial statements) over a long enough period to understand not only the current financial position of a business, but also the trends leading to that position, and how those trends may influence the value of the company.

Appraisers should examine agreements that delineate the rights of ownership of equity or debt securities to determine if there are any peculiarities of legal structure that could affect value. This examination is especially critical for companies with complex capital structures.

Revenue Ruling 83-120 provides guidance regarding the valuation of preferred shares, and, by association, certain long-term debt instruments. It is sometimes necessary to value one or more issues of preference securities to determine the fair market value of the company's common shares.

d) The analyst is expected to review the nature and sources of a company's revenue stream, its cost of goods sold (if applicable), and the details of its operating expenses. Revenue and expense items should be examined in dollar terms, in the form of margins (e.g., as percentages of sales or assets), and in terms of relative growth rates over time. While the language in Rev. Rul. 59-60 does not focus on cash flow, it should be clear that an analysis of "net income available for dividends" requires an understanding of the working capital and capital expenditure requirements of the company.

   The company's balance sheet and income statement are interrelated. As previously discussed, many balance sheet adjustments require a corresponding income statement adjustment. For example, investment assets or excess cash are often segregated from operating assets and added to value at the end of an analysis. Such treatment requires appropriate adjustments to the income statement (i.e., eliminating the associated income and/or expense associated with the investments) to avoid capitalizing their earnings together with operating income.

   The suggestion in Rev. Rul. 59-60 that management may abandon money-losing operations can lead the unsuspecting analyst astray. While it is important to understand divisional profitability, and to focus on money-losing operations for further discussion, it is often dangerous for an appraiser to speculate about which lines of business might be abandoned "with benefit to the company." Sometimes, money-losing operations are just that – money losers. Alternatively, a money-losing operation today may be the seed from which future growth will come. Few companies make money in every division all the time. Appraisers should be wary when speculating about the impact of abandoning lines of business, particularly if the company uses the process of working through money losers to find potential winners. In addition, appraisers who increase the value of a company by omitting losses of a line of business or division should evaluate the potential for continued losses until disposition as well as the costs to dispose of or abandon the operation.

The interpretation of historical financial performance to develop current estimates of earning power is one of the appraiser's most delicate tasks. Appraisers must exercise judgment in the selection of an earning power estimate, such that the forecasted revenues, margins, and earnings (and cash flows) make sense.

e) A company's dividend-paying capacity is ultimately a function of earnings, reinvestment needs, and financing philosophy. Directly capitalizing a measure of dividend-paying capacity is fraught with danger for appraisers. Dividend-paying capacity is often measured by reference to the dividend payout ratios of guideline public companies. If the subject company is highly leveraged or is facing heavy capital expenditure requirements, careless appraisers may end up capitalizing "dividends" which never would or could be paid. This warning is especially pertinent when valuing minority interests in private companies. When valuing a particular shareholder interest, it is difficult to justify capitalizing dividends that a minority shareholder has never received and likely never will receive.

f) There is no such thing as automatic goodwill or intangible value. Some companies are worth more than their net book value, some less. Earnings (or their prospect in the eyes of potential purchasers) are the primary source of goodwill. Although the Ruling seems to suggest goodwill and intangibles of a company are measured discretely, in practice the value of goodwill and intangibles is usually a byproduct of the overall appraisal process rather than the subject of direct investigation. Chapter 5 provides an in-depth discussion of the sources of goodwill and intangible value.

g) Actual transactions in the stock of the subject company may provide important evidence regarding fair market value. To the extent that transactions occur at arm's length, such sales indicate the price(s) at which parties with opposing economic interests engaged in trades. Transactions among family members may or may not be arm's length; however, they will seldom be considered heavily in a tax-related appraisal, especially if such consideration benefits the taxpayer. This section also suggests that transactions of minority interests may provide little beneficial evidence regarding the value of controlling interests.

While Rev. Rul. 59-60 is the definitive ruling regarding the valuation of business interests for estate tax and gift tax purposes, the only guidance with respect to the debated concepts surrounding control premiums, minority interest discounts, and marketability discounts is contained in a single sentence of this section.

While the guidance is limited, the Ruling does appear, on balance, to embrace the conventional wisdom of valuation which suggests there are three basic levels of value. The actively traded stock of a public company is the implied reference point in this discussion. That is the middle level of value which can be described as that of a marketable minority interest or as-if-freely-traded in Figure 1-1.

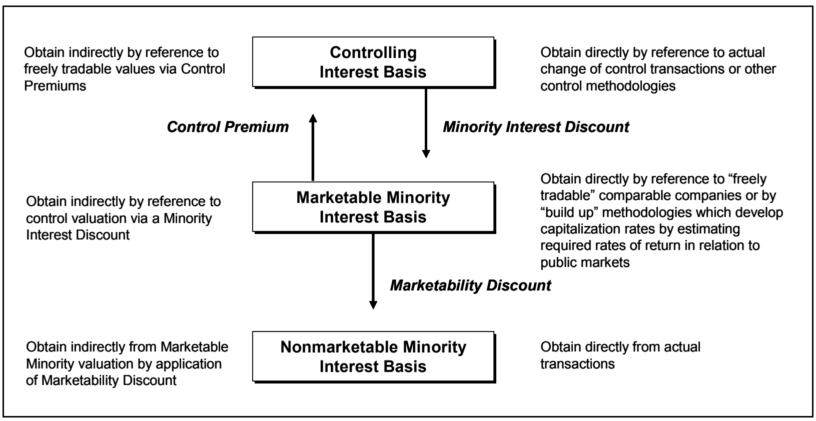

Figure 1 - 1

The nonmarketable minority interest is the lowest level of value. The marketability discount is the difference between the value of a subject minority interest if it enjoyed ready marketability and the value of that same interest lacking marketability. In practice, this discount is generally expressed as a percentage of the marketable minority value. Note, however, that there is no specific mention of the concept of a marketability discount at this point in the Ruling.

The highest level of value is called the controlling interest level of value. Analogous to the marketability discount, the control premium is the difference between the value of a subject interest that exercises control over the company and the value of that same interest lacking control (but enjoying marketability). In practice, the control premium is generally expressed as a percentage of the marketable minority value. When the difference is expressed as a percentage of the controlling interest value, it is referred to as a minority interest discount. Both the concept of the control premium and that of the marketability discount have been addressed in numerous studies by appraisal professionals and by the various courts.

Two oft-forgotten concepts are important in the discussion of valuation discounts and premiums. The first is that no premium or discount has any meaning apart from a well-defined base value to which it is applied. A marketability discount has no meaning apart from a marketable minority interest value to which it is applied. Likewise with a control premium. In the same way, a minority interest discount is meaningless in the absence of a controlling interest value.

The second is that valuation discounts and premiums are ultimately outputs of, not inputs to, a well-reasoned valuation. Discounts and premiums are shorthand ways of describing differences in value attributable to economic differences between related subject interests. They are not, and cannot be treated as, the source of valuation differences. Investors evaluate the worth of a particular interest by reference to the expected cash flows, growth potential, and risk characteristics of that interest. Varying expectations among interests lead to discounts and premiums.

Revenue Ruling 59-60 was amplified by Revenue Ruling 77-287 nearly 20 years later. Revenue Ruling 77-287 addresses the valuation of restricted shares of publicly traded companies, where the only difference between the restricted, or unregistered, shares and their freely traded counterparts is limited marketability. Somehow, in this amplification of Rev. Rul. 59-60, the IRS managed to avoid using the term marketability discount altogether. It does, nevertheless, contain useful information on the analysis of restricted securities, referencing and summarizing information from the SEC Institutional Investor Studies of the late 1960s and early 1970s that has long been quoted in support of marketability discounts for minority interests of private companies.

(h) We live in a world of alternative, or competing, investments. This final factor suggests that comparisons should be made with "corporations engaged in the same or similar line of business." Such comparisons are often more easily described than executed. Often, there simply are not public companies in the same business as the subject private company. In other cases, while a public company may have a division or subsidiary that is in the identical business, it represents such a small portion of the public entity's business that comparisons are not meaningful.

Appraisers sometimes attempt to use the "or similar line of business" guidance to identify public companies with similar marketing, manufacturing, distribution, or other characteristics. But neither this guidance nor common sense suggests that analysts should use "market basket groups" of companies in lieu of discrete groups of companies with some basis of comparability. For example, it would rarely be appropriate to use data pertaining to a market index as a basis to develop a capitalization rate for a small, closely held manufacturing business.

The market for publicly traded stocks is much deeper and more liquid today than in 1959, so that the requirement that comparable companies be "actively traded by the public" is met by most companies on the national NASDAQ market, as well as many other companies in the over-the-counter markets. While a conclusion that a public company has an active market is a matter of judgment; information regarding trading activity, market makers, and research followed by investment banking firms is available for all public securities.

In identifying guideline companies, experienced appraisers typically go through a series of screens to insure comparability with a subject private company. For example, if the subject company generates annual revenues of $20 million in the flexible packaging manufacturing industry, the successive screens might resemble the following:

1) Screen all public companies for a primary line of business in the relevant SIC or NAICS code. This screen might yield one hundred or more suspects.

2) Because the subject has only $20 million in sales, one would likely eliminate all companies with revenue above some judgmental hurdle as too large for meaningful comparison.

3) Assuming that the subject has been consistently profitable for the last five years, one might screen the remaining public companies for a similar history of profitability.

4) Depending on the circumstances, the appraiser may run an additional screen to identify those companies that earn similar operating margins, or have exhibited similar growth patterns.

5) At this point, the appraiser should study detailed descriptive and financial information on the remaining public companies and eliminate those that are obviously not comparable.

Following these screens, the remaining group may be a small number of “comparables” or as many as 10 or more. The fact that a public company is in the same or a similar line of business as the subject private company does not necessarily render the company a reasonable source of comparative valuation data unless it passes the tests of “other relevant factors.”

SECTION 5. WEIGHT TO BE ACCORDED VARIOUS FACTORS

After several pages of fairly specific guidance, the remaining sections of the Ruling provide more general expectations and guidance. In most cases, appraisers will apply different valuation methods, yielding multiple indications of value. The relative weights accorded earnings-based indications of value versus other indications, including asset-based indications of value, will depend upon a variety of factors, including: 1) the purpose of the appraisal; 2) whether the subject block of stock represents a controlling or a minority interest; 3) the degree of anticipated earning power in relationship to asset values; 4) the type of company (e.g., operating versus asset-holding); 5) the nature of the assets in question; and 6) numerous other factors. Judgment is clearly required in the application of weights to various valuation indications.

Section 5(b) addresses the value of asset-holding entities, including the importance of the value of such a company's net assets at the valuation date. We consider the implication of Rev. Rul. 59-60 for the valuation of asset-holding entities in greater detail in Chapter 4.

SECTION 6. CAPITALIZATION RATES

Section 6 begins by acknowledging that the development of appropriate capitalization rates is one of the more difficult aspects of valuation. Nevertheless, or perhaps as a result, this subject gets a total coverage of seven sentences in Rev. Rul. 59-60.

The rates of return and dividend yields (and implied capitalization factors or valuation multiples) found in the public stock markets display wide variation across industries and across time, as well as between different companies in the same industry.

Section 6 notes that 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.

Conceptually, we can represent the basic valuation equation as:

$$\text{Value} = \text{Earnings} \times \text{Multiple}$$

Capitalization rates are another way of expressing the valuation multiple. Valuation disputes often reflect disagreement with respect to the appropriate multiple rather than the appropriate measure of earnings. It is notable that the Ruling has comparatively little guidance to offer at this most critical juncture of the appraisal process. Common sense, reasonableness, and informed judgment are indispensable in deriving appropriate capitalization rates.

SECTION 7. AVERAGE OF FACTORS

This brief section is of limited help to either appraisers or users of appraisal reports. The purpose of any fair market value determination is to develop a conclusion of value for a specific equity interest for a specific purpose as of a specific point in time. How else can an analyst synthesize often disparate value indications such as low capitalized earnings and high net asset values, or the reverse, high capitalized earnings and low net asset values, except by some explicit or implicit averaging process? Some appraisers make their averaging explicit. Others, by selecting a conclusion within a range of indicated values, use an implicit averaging process. How else could they pick a value at the upper end or the lower end or the middle of the range? The guidance provided in this paragraph can be safely ignored.

SECTION 8. RESTRICTIVE AGREEMENTS

Restrictive agreements applicable to closely held shares should always be considered by appraisers in determinations of fair market value. Sometimes the terms of such agreements define value as with a binding buy-sell agreement that is adequately funded and determinative of the pricing of transfers among shareholders. In other cases, restrictions on transfer can be detrimental to value. For example, if the restrictions make it difficult to entice qualified buyers to comply with the terms of the agreement, the marketability, and therefore the value, of the subject shares, may be diminished. In yet other cases, shareholder agreements enhance marketability. The put option generally applicable to shares owned by an employee stock ownership plan can augment value by reducing the marketability discount that otherwise might be appropriate to the shares.

This section also mentions the case of a decedent whose shares are subject to the company's option to (re)purchase the subject shares at a certain price. That price defines value for the estate that must tender the shares at that price. However, that same option cannot be invoked to define value for gift tax purposes. This discussion of restrictive agreements was expanded upon greatly in Sections 2701-2703 of the Internal Revenue Code. The fundamental question to ask is: "Would arm's length parties reasonably enter into an agreement like the subject restrictive agreement?" If so, the agreement may determine fair market value. If not, then the agreement will likely not determine fair market value.

The degree of consideration given to restrictive agreements will, of course, relate to the facts and circumstances of each case. Always alert for potentially abusive situations, the IRS clearly states in Rev. Rul. 59-60 that it will not recognize agreements that grant a shareholder considerably more discretion during his or her life, than at death.

CONCLUSION

Revenue Ruling 59-60 is a helpful and prescient guide to appraisers and users of appraisal reports. The basic eight factors presented in Section 4 provide an essential base for any gift or estate tax appraisal. If appraisers consistently considered the basic eight factors in light of the critical three factors of common sense, informed judgment, and reasonableness, many appraisal disagreements would simply vanish.

Of course, it should not be surprising that a document written in 1959 fails to address all the challenges facing business appraisers today. Significantly, the Ruling is virtually silent at two critical points in the appraisal process. First, the guidance regarding the selection of appropriate valuation multiples, or capitalization rates in Section 6 is quite abbreviated. This is a major area of disagreement in contested appraisals. Second, there is no discussion of two major discounts that may be applicable and must be considered in every minority interest appraisal – the minority interest discount and the marketability discount. It should come as no surprise that the appropriateness and extent of both of these discounts are often the subject of further disagreement in contested appraisals.

Revenue Ruling 59-60 is a remarkable document, having aged gracefully from its initial publication in 1959. The perspective, insight, and common sense wisdom contained in the Ruling is as important to appraisers today as it was in 1959.

Chapter 2
Fair Market Value versus the Real World

INTRODUCTION

One of the most commonly cited, but potentially most misunderstood, components of Revenue Ruling 59-60 is the definition of fair market value, the standard of value for federal gift and estate tax valuation requirements. Appraisers, estate planners, and clients must understand that the implied world of fair market value is not the so-called real world.

The world of fair market value is, rather, a hypothetical world whose inhabitants, by definition, behave in specific and predictable ways, guided only by an unswerving devotion to economic rationality. The real world, on the other hand, is populated by real people, who are quite capable of behaving unpredictably, engaging in transactions for a host of reasons, some providing more evidence of economic rationality than others. It should come as no surprise, then, that what we observe in the real world is not always consistent with the definition of fair market value.

This chapter is structured around the definition of fair market value. We examine eight elements of the definition from the perspective of hypothetical buyers and sellers in the fair market value world, and their counterparts in the real world.

FAIR MARKET VALUE DEFINED

Revenue Ruling 59-60 provides a working definition of fair market value:

> 2.2 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 [1] the price at which the property would change hands [2] between a willing buyer [3] and a willing seller [4] when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, [5] both parties having reasonable knowledge of the relevant facts. Court decisions frequently state in addition that [6] the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and [7] to be well informed about the property and concerning [8] the market for such property. [numbering not in original]

This definition identifies the principal characteristics of the hypothetical world of fair market value. The inserted numbers denote the eight elements in the definition of fair market value we will elaborate on in the remainder of this chapter. All valuation judgments under Revenue Ruling 59-60, including those surrounding the definition of value, must be evaluated in the context of common sense, informed judgment, and reasonableness (identified in Section 3.01 of the Ruling).

One of the most complete discussions of the definition of fair market value in the United States is found in the *Internal Revenue Service Valuation Training for Appeals Officers Coursebook*. While the *IRS Coursebook* is only for training purposes and cannot be used to set or sustain a technical position, appraisers and attorneys would do well to read it. It addresses many of the elements discussed below.

THE ELEMENTS OF FAIR MARKET VALUE

In the remainder of this chapter, we focus on the eight elements previously noted in the definition of fair market value in Revenue Ruling 59-60.

1. A Transaction Price

Fair market value is "the price at which the property would change hands," in other words, a transaction price. The subject property is assumed to change hands in a hypothetical transaction. Fair market value is not a measure of an asset's utility to a particular investor, but rather the price at which a transaction involving the asset would occur.

It is critical to note that the *price* at which a transaction is consummated is not synonymous with the *proceeds* received by the seller. Transaction and related costs incurred to complete a sale reduce proceeds, not price. Other costs borne by the seller, such as those related to deferred maintenance, for example, may impinge on the company's value. Appraisers should therefore distinguish between costs that influence value (price) and proceeds (price less transaction costs).

Elsewhere in Rev. Rul. 59-60, the fair market value price is described in terms of money or money's worth, so the fair market value price is a cash-equivalent concept. It is paid in terms of dollars today or the present value of consideration to be received in the future. This can raise obstacles to the use of actual transactions in the real world to derive indications of fair market value:

» Was the quoted transaction price paid in cash at closing? If a portion was deferred, what is the appropriate discount rate with which to express present value?

» If stock or other non-monetary assets were received, what is the fair market value of that consideration?

» If an earnout or other form of contingent consideration was negotiated, what is the probability-adjusted present value of the potential future payments?

» If there were parallel transactions (i.e., employment agreement with, or lease of property from, the seller), what effect, if any, did the terms of those transactions have on the transaction price paid?

» What actually changed hands – ownership of the business, or the assets of the business? Fair market value relates to a transaction involving the subject property. The subject of most business valuations performed under Revenue Ruling 59-60 is the stock or other ownership interest in a business, yet many transactions in the real world involve the assets, not the stock, of the business.

2. A Willing Buyer

The hypothetical buyer in the world of fair market value is willing to acquire the subject property. The hypothetical buyer is presumably situated so that purchase of the subject property is a reasonable business judgment. Furthermore, the hypothetical buyer is inclined to acquire the subject asset "if the price is right." Hypothetical buyers assess the price they are willing to pay on the basis of sound business, financial, and economic principles. In other words, the hypothetical willing buyer is a rational buyer.

In the real world, of course, actual buyers are not always so disciplined. Buyers may make decisions on other bases; such behavior is not consistent with fair market value.

3. A Willing Seller

Likewise, the hypothetical seller in the world of fair market value is willing to sell the subject property. While the hypothetical seller obviously owns the subject property, he is presumably situated such that sale of the property, with the attendant redeployment, distribution, or consumption of the resulting proceeds, is a reasonable business judgment. As with the hypothetical buyer, the hypothetical seller is inclined to transact at an appropriate price, approaching the determination of that price with equal rigor and overall rationality.

Actual business owners in the real world, however, are often either disinclined to sell, or have never given much thought to what might constitute an appropriate price. Particularly in the case of smaller, family-owned businesses, non-economic factors can play a significant role in deciding whether an actual sale proposal will be entertained. If the definition of fair market value is to hold up, we must assume that the seller is indeed willing to negotiate a transaction on reasonable terms.

Sellers that elect not to engage in a transaction become, in effect, buyers who acquire (by retaining) the subject interest. So every hypothetical seller is evaluating the same economic and financial factors under consideration by the relevant group of hypothetical buyers.

The importance of the willingness of the hypothetical buyers and sellers in the world of fair market value is difficult to overemphasize. It is occasionally tempting to argue that because one is not personally situated or inclined to buy the subject property, it therefore has very little value. Conversely, it is sometimes argued that since the actual owner has (perhaps fervently) expressed a disinclination to sell, the property should be valued dearly. Either argument may express the facts on the ground of the real world, but neither is compelling with respect to determining fair market value.

Recalling the first element in the definition of fair market value, a hypothetical transaction presupposes that the needs and concerns of both buyers and sellers have been sufficiently addressed such that a meeting of the (hypothetical) minds is reached.

4. An Absence of Compulsion

The question of compulsion is a close cousin to that of willingness. Although both hypothetical parties are willing to transact, neither is assumed to be under any compulsion or pressure to do so. Compulsion invariably works adverse to the compelled party's interests. A motivated buyer may be induced to pay a premium to acquire an asset, while a motivated seller may accept a discounted sales price to complete a transaction.

Compulsion should not be equated with irrationality. In the real world, buyers and sellers acting under compulsion may have a perfectly rational basis for doing so. An actual buyer, recognizing the compelling strategic attributes of a specific property may rationally pay a premium price, relative to the broader market of potential acquirers who are not positioned to reap the same strategic benefits. Similarly, an actual distressed seller may rationally accept a discounted sales price to achieve a broader economic objective.

The absence of compulsion suggests that fair market value is likely neither the highest nor lowest price at which a transaction in the subject asset could conceivably be consummated in the real world. Rather, fair market value should reflect the consensus expectations of a group of buyers and sellers with typical motivations to achieve reasonable returns based on the expected cash flows of an investment.

When discussing compulsion, we arrive at another roadblock with respect to using actual transactions as direct evidence of fair market value, even if the transactions occurred between independent parties. The mere fact of the parties' independence yields no evidence regarding the animating motivations of either. In many, if not most, cases, we may never know or understand the actual motivation of the parties. But we ought to analyze the economics of actual transactions and make informed judgments regarding the relevance of the transaction to determine fair market value.

5. Reasonable Knowledge

In the fair market value world, both hypothetical parties possess reasonable knowledge of the relevant facts regarding the subject asset. This is critical, because in the real world the relevant facts regarding many assets are not widely disseminated. The lack of access to relevant data regarding the subject company is a barrier to most potential investors in the real world. This barrier does not exist in the fair market value world.

Possession of the reasonable knowledge of relevant facts stipulated in the definition of fair market value is often described as being fully informed. In the real world, actual buyers and sellers are not necessarily fully informed. Why is it that the surprises that happen after acquisitions are invariably adverse to buyers? From a seller's viewpoint, assurances from the buyer that "nothing will change after the merger" are rarely realized. Many issues that come to light after transactions were quite knowable beforehand with reasonable due diligence. Actual buyers and sellers, whether through economic compulsion or simple oversight, often transact without meeting the fully informed standard.

Reasonable knowledge also implies competence with respect to the subject asset class. All but the most intrepid real world investors specialize in following, analyzing, and evaluating a particular asset class, such as real estate, private equity, or small-cap common stocks. The reasonable knowledge element establishes that, in the world of fair market value, the hypothetical willing parties are competent to transact in the subject asset class, regardless of how narrow it may be.

Further, reasonable knowledge implies a similar level of negotiating ability between hypothetical buyers and sellers. In the real world, buyers of companies often have far more experience negotiating purchases than sellers, who may never have sold a company before. This real world disparity has no place in the world of fair market value.

Reasonable Knowledge and the Future. Before proceeding with the next element, a brief aside is appropriate. In the real world, transactions are based on facts and circumstances known up to the minute of closing, including a reasonably informed outlook for the future. Such an outlook, of course, rarely corresponds perfectly with actual subsequent events. Likewise, in the world of fair market value, reasonable knowledge does not suggest that the hypothetical market participants possess unnatural prescience. This implies both that appraisers cannot be asked to divine the unknowable, and that knowledge of actual subsequent events cannot properly be attributed to hypothetical buyers and sellers.

Appraisers preparing after-the-fact valuations must not abuse the standard of reasonable knowledge based on facts that became manifest, or events that occurred, subsequent to the historical transaction date (regardless of the elapsed time between the valuation date and preparation of the appraisal). When knowledge of so-called subsequent events or facts is helpful, it may prove tempting to believe that such events were certain (or the facts were reasonably knowable) at the valuation date. Independent appraisers ought to resist this temptation when determining fair market value.

In some instances, the fact that an event might occur in the future is known at the time of a transaction or at a valuation date. What is not generally known is when or with what probability the event might occur. Appraisers must assess those probabilities and incorporate the risks or potential benefits appropriately in their appraisals the way that reasonably informed hypothetical willing investors might, based on information available as of a valuation date.

This brief discussion of the reasonable knowledge component of the definition of fair market value underscores the importance of exercising the critical three factors of common sense, informed judgment, and reasonableness. Subsequent events create a challenging environment for staking out the appropriate bounds of reasonable knowledge. The remaining elements of the definition enhance this discussion of reasonable knowledge.

6. An Ability and Willingness to Trade

The hypothetical parties in the world of fair market value are able to engage in a transaction involving the subject asset; in other words, each of the parties is assumed to have the financial capacity to engage in the subject transaction. Setting aside the possibility for the ill-advised use of leverage, buyers and sellers in the real world necessarily have the ability to transact.

For business interests that may be large, the requisite financial resources to allow reasonable purchase of the asset may limit the number of potential buyers. Consider, for example, a subject interest with fair market value on the order of $500,000. If we assume that most rational investors would not place more than 10% or so of their portfolios in any single investment (about the minimum number of investments to achieve reasonable diversification if all the individual investments are publicly traded securities), then the hypothetical willing buyers for that interest are limited to investors with liquid financial assets on the order of $5 million or more. Given the illiquidity of the many business interests subject to appraisal, investors may be willing to allocate less to a single investment, suggesting an even larger portfolio.

Appraisers should carefully assess the universe of hypothetical investors. Specifically, appraisers should analyze the investment requirements of the relevant universe of hypothetical investors. Attorneys and other users of appraisal reports should expect such considerations to be made, either explicitly or implicitly, in appraisal reports.

7. A Subject Property

Both hypothetical parties in the fair market value world are well-informed about the property that is the subject of the appraisal. We previously discussed the notion of reasonable knowledge with respect to the subject asset class. This element of the fair market value definition extends the point of being reasonably informed in a general sense to being well-informed with respect to the particular subject property.

Further, the hypothetical parties assess the economic and financial attributes of the subject property itself, not the synergies, strategic impetus, or psychological benefit that particular buyers or sellers may attach to the asset. In the real world, of course, it is those derivative benefits that often take center stage in transaction negotiations.

8. An Appropriate Market

The last element of the definition of fair market value carries the concept of reasonably informed one step further. Both parties are assumed to be knowledgeable, not only about the specific property, but also about the market for the relevant property. Knowledge of the market for a property assumes an understanding of industry conditions and outlook as well as local, regional, and/or national economic conditions.

As evident from this brief analysis, the definition of fair market value provided in Revenue Ruling 59-60 does not lend itself to simplistic interpretation. Appraisers and users of valuation reports should not be content with a glib recitation of the definition, but rather should develop a more nuanced familiarity with the individual elements of the definition.

CONCLUSION

The world of fair market value is not the real world. For appraisers and their clients, however, the world of fair market value is very real. As noted in the *IRS Coursebook*:

> . . . 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 valuation standards are applied, the conclusion will be defective.

Appraisers do well to focus on the definitional elements of fair market value while developing opinions of fair market value and describing those opinions in valuation reports. Attorneys and other users of appraisals should expect no less.

Chapter 3
What Revenue Ruling 59-60 Means for the Valuation of Operating Companies

The business appraiser's job is to translate the general wisdom and insights of Revenue Ruling 59-60 into particular valuation techniques and judgments. In this chapter, we relate the guidance found in the Ruling to the practice of valuing private operating companies.

This chapter begins with a brief discussion of the salient characteristics of operating companies. We then review the implications of the "basic eight factors" (or the "basic eight") for the appraisal of operating companies. Finally, we examine some of the primary judgments made by appraisers in light of the guidance in other sections of Rev. Rul. 59-60.

Most of the considerations and approaches prescribed by Rev. Rul. 59-60 are so compelling that today most appraisers view them as common sense. Of course, common sense is not always evident in appraisals prepared under the Ruling. The point here is not that the prescriptions of Rev. Rul. 59-60 are obvious, and therefore, unnecessary. To the contrary, in the context of valuing operating businesses from 50+ years ago to the present, Rev. Rul. 59-60 has provided an invaluable framework for appraisers and users of appraisal reports. While that framework is not all-inclusive, it is an indispensable foundation upon which the appraiser of operating companies may build reasonable valuations.

CHARACTERISTICS OF OPERATING COMPANIES

Operating companies exhibit such a wide array of characteristics that they may best be defined inversely, or in a negative sense. Operating companies are not asset-holding entities (which are discussed in greater detail in Chapter 4). Asset-holding entities own assets, such as real estate, marketable securities, or promissory notes. Asset-holding entities aim to earn returns in the form of capital appreciation, dividends, interest income, and rental income.

Operating companies, on the other hand, either provide a service or engage in the manufacture, distribution, or sale of products in order to generate revenue. The primary source of returns for operating businesses is typically earnings from operations; that is, revenue, less the cost of goods sold and selling, general, and administrative expenses, including labor costs. Operating companies may be asset-intensive (e.g., telecommunications company) or labor-intensive (e.g., law firm). Asset-intensive companies incur relatively more capital costs while labor-intensive companies report relatively more labor costs. For all operating companies, raw materials, capital, and labor are the primary inputs from which the operating company produces output.

THE BASIC EIGHT FACTORS

Looking at the list of the basic eight factors, even those untrained in the art of business valuation would understand that the value of an operating company depends on these factors. The basic eight factors were discussed in detail in Chapter 1. In the following section, we briefly review the factors, with special emphasis on operating companies.

1) *The nature of the business and the history of the enterprise from its inception.* An analysis of an operating company's nature and history should provide some perspective with respect to earnings volatility, growth patterns, and business diversification and concentrations.

2) *The economic outlook in general and the condition and outlook of the specific industry in particular.* Through an examination of macroeconomic conditions and an industry-specific outlook, an appraiser can better understand an operating company's business dynamics and competitive position. Such an examination can provide a valuable perspective on the subject company's exposure to events and forces that are outside management's influence.

3) *The book value of the stock and the financial condition of the business.* In assessing fair market value, an appraiser should evaluate the subject company's book value and financial position, including the amount of leverage in the capital structure, debt covenants, and debt servicing ability. The company's liquidity position and ability to access additional capital if needed are also telling. Operating companies characterized by greater financial leverage and diminished liquidity are more likely to experience financial distress and, therefore, have a higher risk profile.

4) *The earning capacity of the company.* An operating company's earning capacity is often discerned by reference to historical results, adjusted for non-recurring items and the like. The appraiser applies common sense, reasonableness, and informed judgment to translate the company's historical results into an estimate of future earning capacity. Absent a pending or expected liquidation, there is a strong positive relationship between projected future earnings (or cash flow) capacity and business value.

5) *The dividend-paying capacity.* As with earnings, there is a strong positive relationship between dividend-paying capacity and business value. The dividends paid historically may not necessarily indicate a company's dividend-paying capacity. Capacity is just one of several factors that inform a company's decision to pay or not pay dividends. Without excess liquidity or positive earnings capacity, an operating company is unlikely to have substantial dividend-paying capacity.

6) *Whether or not the enterprise has goodwill or other intangible value.* Intangible value can be positive or negative; it represents the difference between fair market value and tangible adjusted book value. Rev. Rul. 59-60 states the following: "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."

7) *Sales of the stock and the size of the block of stock to be valued.* Actual transactions in the stock of an operating company can provide

important evidence regarding fair market value. To the extent that transactions occur at arm's length, such sales indicate the price(s) at which parties with opposing economic interests engaged in trades.

8) *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.* The fundamental premise of this statement is that we can obtain information about the value of private securities by appropriate comparisons with the securities of public companies. This seemingly straightforward guidance is complicated in application by the challenge of identifying suitably comparable public companies.

VALUATION OF OPERATING COMPANIES

Valuation Approaches

Based primarily upon the framework outlined in Rev. Rul. 59-60, business appraisers recognize three general approaches to value: the asset, income, and market approaches. Within each approach, several different methods (and variations on those methods) are used to develop indications of value.

Asset Approach

The asset approach is a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities. Asset-based valuation methods include those methods that seek to write up (or down) or otherwise adjust the various tangible and/or intangible assets of an enterprise.

When valuing an operating company, valuation methods under the asset approach may sometimes take a backseat to those under the income and market approaches. While some appraisers will occasionally attempt to value the subject company's intangible assets directly for inclusion in the asset approach, other appraisers will often consider only the tangible net assets of the subject company when applying methods under the asset approach. The intangible value of the company, if any, is presumably manifest in valuation methods under the income and market approaches. The asset approach may be of limited relevance when valuing companies with substantial intangible asset value.

Income Approach

The income approach is a general way of determining a value indication of a business, business ownership interest, security or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount. Valuation methods under the income approach include those methods that provide for the direct capitalization of earnings estimates, as well as valuation methods calling for the forecasting of future benefits (earnings or cash flows) and then discounting those benefits to the present at an appropriate discount rate.

Valuation methods under the income approach often represent the cornerstone of operating company appraisals. Unless liquidation or dissolution of the operating company is anticipated, appraisers will typically employ one or more methods under the income approach. The most commonly used income methods are the single period capitalization of earnings and the multi-period discounted cash flow methods. Use of the single period capitalization method is occasionally constrained by certain implicit assumptions, including the expectation that earnings will grow at a constant rate into perpetuity. Use of the multi-period discounted cash flow method is not always appropriate, as it requires a discrete forecast of earnings and cash flows. For some operating companies, such a forecast may not exist, or may not be reliably created.

Market Approach

The market approach is a general way of determining a value indication of a business, business ownership interest, security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities or intangible assets that have been sold. Market methods include a variety of methods that compare the subject with transactions involving similar investments, including publicly traded guideline companies and sales involving controlling interests in public or private guideline companies. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

The reliability of valuation methods under the market approach depends on the availability of timely market data from transactions involving comparable businesses. Sifting through the thousands of potentially comparable public companies, appraisers evaluate comparability on the basis of several measures: the product or service provided by the company, the size, growth and profitability of the company, the financial position of the company, and other measures that may be relevant to the particular industry. The pool of data available for transactions involving comparable private companies is small, and appraisers must carefully scrutinize the quality and relevance of such data before giving explicit weight to the data in an appraisal.

Application of Revenue Ruling 59-60 to Valuation Judgments

In the following sections, we provide insight into how appraisers make some of the critical valuation judgments identified in the Ruling. When valuing operating companies, the key valuation judgments include developing an estimate of ongoing earning power (or an earnings forecast), estimating the appropriate discount rate, identifying comparable public companies, applying observed market data to the subject company, and developing a correlated indication of value.

Ongoing Earning Power

The earning capacity of an operating company can generally be expressed in either of two ways, as a discrete forecast of earnings in particular future years, or as an estimate of the company's ongoing earning power. Ongoing earning power is best understood not as a specific forecast of any particular subsequent period's earnings, but rather as a base from which the company's earnings are expected to grow with the full understanding that results for any given particular year are likely to exceed or fall short of the estimate of ongoing earning power.

Appraisers typically preface their estimate of ongoing earning power with an analysis of the company's historical earnings, consistent with the guidance in

Section 4.02(d) of the Ruling. Development of ongoing earning power for an operating company generally follows a two step process. First, necessary adjustments are made to the reported revenues and expenses for each of the years analyzed (historical and projected). Second, weights are applied to the adjusted results for each year to derive a measure of ongoing earning power.

Appraisers typically consider adjustments for unusual or non-recurring events, income or expense associated with non-operating assets and liabilities, results of discontinued operations, and so-called normalizing adjustments.

» Adjustments for unusual or non-recurring events are rarely controversial, although judgment is required in assessing whether some large expenses are truly non-recurring or just part of the occasional cost of doing business.

» It is necessary to adjust for income or expense associated with assets or liabilities determined to be non-operating. Non-operating assets are those deemed not to be integral to the operations of the company. As such, their value is added to the value of the business operations to derive the total value of the company. The value of the non-operating asset is presumably the risk-adjusted present value of the expected cash flows to be derived from the asset. If the reported earnings of the company are not adjusted for those cash flows, the value of the non-operating asset would effectively be accounted for in the valuation twice. The same logic applies (in reverse) for non-operating liabilities.

» For operations that have been discontinued and completely disposed of at the valuation date, adjustment for prior results is relatively straightforward, although appraisers must be careful to adjust for both the revenue and expenses of the unit that will no longer be earned or incurred subsequent to disposition. When operations are in the process of being discontinued, costs of sale or abandonment and interim losses expected prior to final disposition should not be ignored in the valuation. Some operating companies have a history of regularly starting multiple lines of business and discontinuing underperformers. In such cases, adjustment for discontinued operations may potentially be misleading.

» Normalizing adjustments relate to discretionary items of revenue or expense that a hypothetical willing buyer would not expect to persist after a change in control. For example, an operating company may pay compensation to owners well in excess of the market rate for services actually provided. When evaluating the earning capacity of a business, the hypothetical willing buyer is likely to ignore such discretionary items. Some appraisers contend that such normalizing adjustments are not appropriate to all appraisals, for instance when determining the fair market value of a small minority interest that has limited or no influence over such items.

Once adjusted earnings have been developed for the various years under consideration, weights are often applied to the adjusted results to derive a weighted average, or ongoing measure of earning power. The appropriate application of weights to the results for various years should be the product of careful study of the company, its industry, and the local and national economy, and hard-won years of appraisal experience. The weights applied often reflect consideration of the historical growth in revenue, trends in margins, and industry cyclicality, among other factors.

Capitalization Rate

Section 6 of the Ruling provides a brief discussion of capitalization rates. Appraisers use capitalization rates to convert a single-period estimate of earnings or cash flow into an indication of value. A capitalization rate consists of two distinct components: a discount rate (alternatively referred to as a required return) and an expected growth rate for the earnings or cash flow measure capitalized. While responsible appraisers approach these judgments in a rigorous and disciplined manner, the element of informed judgment can never be completely exorcised.

Investors face an array of alternative investment opportunities. The inhabitants of the fair market value world described in Chapter 2 evaluate these competing investments on the basis of perceived risk and anticipated return. When comparing two investments, investors will demand a higher anticipated return from the investment with greater perceived risk. Regardless of the particular technique employed, appraisers should attempt to emulate this perspective when estimating discount rates.

The essence of discount rate determination consists of situating the subject interest within the complex world of alternative investment opportunities. Is the subject investment riskier than short-term government bonds, long-term government bonds, or the various grades of corporate bonds? What about large public companies? Small public companies? What about the spectrum of other asset classes – private equity, venture capital, art & antiques, etc.? The answer to these questions, in consultation with available return benchmarks, establishes a range of discount rates. This range, however, may potentially be rather wide, and the appraiser will have to summon all the common sense, reasonableness, and informed judgment at his disposal to reach a conclusion.

Estimation of expected growth rates requires a comparable dose of judgment. As with discount rates, appraisers do well to think in terms of benchmarks. Are the earnings likely to grow faster or slower than sales (in other words, are margins likely to expand or contract)? Is sales growth likely to outpace inflation? The growth of the economy (the truism that a single company cannot grow faster than the economy in the long-run is, from a practical perspective, irrelevant to most valuation assignments)? What is the outlook for the industry? Is the subject company's relative position in the industry strengthening or weakening? Appraisers should endeavor to relate the expected growth rate to these benchmarks.

Estimation of the discount rate and expected growth rate for the subject company does not signal that the appraiser's appeals to judgment are finished. Rather, the capitalization rate that results from the two judgments must in turn be evaluated for reasonableness. The appraiser should carefully consider whether and how the resulting capitalization rate corresponds to those observed in arm's length market transactions involving similar interests.

Selecting and Applying Market Data

The application of judgment is not limited to the income approach. Applying the market approach, appraisers must exercise judgment when selecting what companies, of the thousands that are publicly traded, provide useful valuation benchmarks for the subject private company. There are no simple bright-line tests to apply in the selection of guideline public companies. The industry or sector of the subject company is not always a foolproof basis for establishing comparability. For example, when valuing a private distributor, the publicly traded manufacturer of the product distributed may not be an appropriate guideline company.

The objective of the guideline public company method is to derive a capitalization rate to apply to an appropriate financial measure (revenue, EBITDA, net income, book value, etc.). The market prices for the selected guideline public companies should, by way of analogy, help the appraiser ascertain the market's perception of the risk profile and growth potential of the subject private company (the two components of a capitalization rate discussed previously). Some analogies are, of course, more apt than others. Even when the analogy is not perfect, some appraisers prefer to make discrete adjustments to the observed valuation multiples to account for specific attributes pertaining to risk and growth that cause the selected guideline companies to be imperfect. These adjustments, referred to by some as "fundamental adjustments," are used to account for some of the commonly observed differences in the value of private and public companies, which are often the result of size, geographic concentration, access to capital markets, and other factors.

Correlated Indication of Value

Section 5 of Rev. Rul. 59-60 addresses the weight to be accorded to various factors in an appraisal. In the context of an operating company appraisal, judgment is required to reconcile what may be diverging indications of value among the various valuation approaches (or even methods within a single approach).

While averaging widely diverging indications of value from a variety of valuation methods may be appropriate in a particular valuation, appraisers should first probe why such large differences exist. Do indications from the market approach suggest that assumptions made in methods within the income approach be revisited? Or do the results from an income approach shed light on the appropriate fundamental adjustment (or selection of guideline public companies)?

Within the market approach, indications of value can vary widely depending on the financial measure capitalized. The appraiser may glean hints with respect to the weight accorded to a particular indication by considering why such differences occur. Differences between indications derived from capitalizing net income and EBIT are a function of the financing mix. Differences between indications derived from EBIT and EBITDA may reveal varying degrees of asset intensity. Capitalized revenue measures provide a view of "normalized" margins – are the margins of the subject company likely to improve or deteriorate? Finally, capitalizing measures of physical volume (number of subscribers or units sold, for example) reveal unit pricing disparities between the subject and the selected guideline companies.

There can be no fixed formula for weighing indications of value from various valuation methods. Responsible appraisers, recognizing this, will reasonably apply common sense and informed judgment in developing a correlated indication of value.

Levels of Value and Valuation Discounts

A business appraisal prepared under the guidance of Rev. Rul. 59-60 must identify not only the applicable valuation date, but also the specific subject interest to be valued. The ownership and liquidity characteristics of the subject interest affect fair market value. Valuation theory suggests that there are three levels of value applicable to a business or business ownership interest:

» *Controlling interest basis* refers to the value of the enterprise as a whole

» *Marketable minority interest basis* refers to the value of a minority interest, lacking control, but enjoying the benefit of liquidity as if it were freely tradable in an active market

» *Nonmarketable minority interest basis* refers to the value of a minority interest, lacking both control and market liquidity

The relationship between these three levels of value is depicted in Figure 3-1.

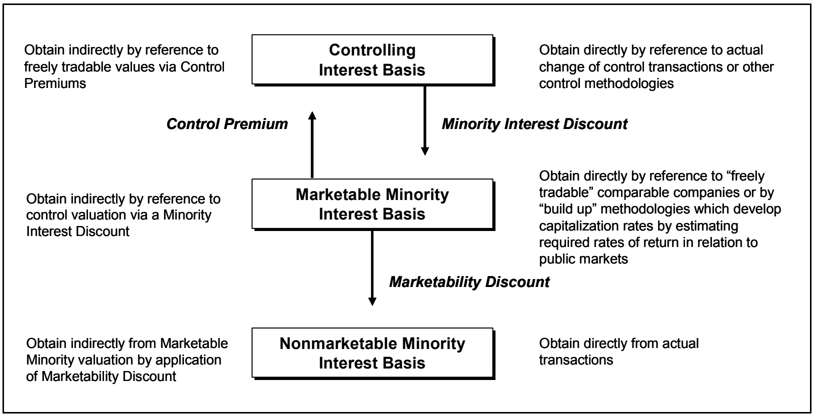

Figure 3 - 1

As indicated in Figure 3-1, appraisers refer to the differences between the various levels of value as discounts or premiums. As discussed in Chapter 1, the difference between the marketable minority interest basis and controlling interest basis is referred to as the control premium (or its counterpart, the minority interest discount), while the difference between the marketable minority interest basis and the nonmarketable minority interest basis is known as the marketability discount.

The state of appraisal art with respect to valuation discounts and premiums continues to evolve. Traditionally, appraisers have looked to published studies of the premiums observed in mergers and acquisitions of public companies as a basis for estimating control premiums and minority interest discounts for operating companies. In recent years, some appraisers have subdivided the controlling interest level of value into two sublevels, the so-called financial control and strategic (or synergistic) control levels. This insight may call into question the use of observed control premiums in some appraisal situations.

Appraisers have traditionally relied on what are fundamentally market or income approaches when estimating marketability discounts applicable to a particular subject interest. Under the market approach, appraisers have relied on studies of transactions that examine either 1) sales of stock in public companies subject to temporary regulatory trading restrictions (known as restricted stock studies), or 2) sales of stock in private companies that later execute an initial public offering (known as pre-IPO studies). Under the income approach, the marketability discount is estimated by quantifying the risk-adjusted present value of the expected benefits to be received by a nonmarketable investor (interim distributions and terminal value).

Regardless of the technique used to estimate valuation discounts or premiums, appraisers and users of appraisal reports should bear in mind that discounts and premiums describe the relationship between two values. They are not valuation inputs that determine either value. Expected cash flows, growth, and risk are valuation inputs. Minority interest discounts, control premiums, and marketability discounts are valuation outputs.

CONCLUSION

Revenue Ruling 59-60 has been a steady guide for appraisers valuing operating companies for the past 50+ years; it remains a valuable companion today, and will likely continue to be so for years to come. The basic eight factors outlined in the Ruling under gird many of the standard approaches and methods developed and used by appraisers. Just as important, Rev. Rul. 59-60 provides a direct, unequivocal assessment of the importance of appraiser judgment in the art of valuation. Without common sense, informed judgment, and reasonableness, the appraisal of complex operating companies is little more than an exercise in arithmetic.

Chapter 4
Revenue Ruling 59-60's Application to Asset-Holding Entities

Unlike an operating company that produces, distributes, or markets products or services to its customers, an asset-holding entity, as the name suggests, holds assets, primarily passive investments. This distinct corporate objective naturally leads to a unique set of valuation concerns and judgments. While the market and income approaches tend to predominate in the valuation of operating companies, the asset approach frequently comes to the fore in the valuation of asset-holding entities.

CHARACTERISTICS OF ASSET-HOLDING ENTITIES

Asset-holding entities own a wide array of assets. The most common asset classes include real estate, marketable securities, controlling or minority interests in private companies, promissory notes, and mineral rights. Asset-holding entities commonly own more than one type of asset, especially combinations that include marketable securities and other passive assets.

Most asset-holding entities are organized as either S corporations, partnerships, or limited liability companies. As a result, they do not pay taxes at the entity level as C corporations do. Instead, all items of taxable income and expense for such entities are passed through to the shareholders or owners, who pay the corresponding taxes at their respective personal tax rates. This structure avoids the so-called double taxation on distributions from C corporations. However, the shareholder's or owner's obligation to pay tax on the pass-through income is independent of the amount of cash distributions, if any. So, unless cash distributions are made to cover the tax liability on pass-through earnings, a shareholder or owner may suffer a negative dividend yield.

VALUATION OF ASSET-HOLDING ENTITIES

In this section, we consider the most relevant considerations in the valuation of asset-holding entities, followed by a brief survey of the typical valuation process for asset-holding entities.

Primary Considerations

Section 5(a) of Rev. Rul. 59-60 confirms the intuition that the asset approach will be of primary significance in the valuation of asset-holding entities.

> 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.

Within the income and market approaches, the ongoing earning power of the subject entity is one of two principal elements of the valuation (the valuation multiple or capitalization rate being the other). Because anticipated earnings are often the primary source of returns to investors in operating companies, the income and market approaches are often the most reliable indications of valuation.

In contrast, the value of asset-holding entities is generally less sensitive to expected income, but is more directly related to the market value of the assets owned. Section 5(b) of the Ruling provides additional insight with respect to the factors most relevant to the valuation of an asset-holding entity.

> 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.

With at least a partial nod to the "efficient market hypothesis," the Ruling suggests that observed market values, based on the sentiment and expectations of the investing public at the valuation date, provide the best valuation evidence for the underlying assets. In other words, appraisers should generally avoid making independent assessments of the value of an asset-holding entity's investments when there is unambiguous market evidence as to that value.

The asset approach generally provides an indication of the value of an asset-holding entity to a controlling shareholder. A shareholder with a controlling interest presumably has the discretion to sell the underlying assets at their respective market values. Most appraisals of asset-holding entities are prepared for minority interests. As a result, some of the most significant valuation judgments in the valuation of asset-holding entities relate to determining appropriate discounts for lack of control and lack of marketability.

Valuation Process

Despite the bewildering array of investments owned by asset-holding entities, the basic valuation process follows the same basic pattern. Since the income and market approaches do not generally provide a reliable indication of value for controlling interests in these entities, appraisers tend to rely instead on net asset value as the primary indication of fair market value at the controlling interest level.

Appraisers generally construct a market value balance sheet to determine net asset value. The entity's investments are listed at their market values as of the valuation date. The market values of any known liabilities are deducted from this total to yield the net asset value. For real estate and other relatively illiquid assets, business appraisers often rely on a current independent appraisal prepared by a qualified appraiser in the relevant field. If no current appraisal is available, an informed and well-documented estimate of market value provided by management of the entity may provide a sufficient basis for determining the net asset value of the entity.

Determining the market value of liquid, readily marketable securities relies on gift and estate tax regulations and is more straightforward. Gift and estate tax regulations provide that the market value of a publicly traded share of stock is the average of the high and low price per share recorded on the valuation date.

The first step in determining the market value of notes receivable is to create an amortization schedule consistent with the terms of the note. The scheduled cash flows are then discounted to the present at an appropriate interest rate, or yield. The appropriate yield generally consists of an observable base rate that reflects the current market environment and additional premiums to account for specific features of the subject note. These features may include, but are not limited to, lack of protective covenants, lack of acceleration clauses, lack of collateral, erratic payment history, and a private placement premium. The market value of the note is the sum of each expected cash flow on the note (interest, principal, and any scheduled balloon payments) discounted to the present value at the estimated yield.

Asset-holding entities generally lack the strategic advantages that give rise to goodwill or other intangible value. While Revenue Ruling 59-60 suggests that the valuation of a closely held business should consider whether the enterprise has goodwill or other intangible value, appraisers generally conclude that asset-holding entities do not have any material goodwill or other intangible value.

The net asset value method provides an indication of value on a controlling interest basis. However, the willing buyers and sellers that populate the world of fair market value are sensitive to the inability of minority shareholders in asset-holding entities to control management of the portfolio, distribution of investment earnings, or the ultimate disposition of the investments. As a result, the fair market value of minority interests is generally less than that indicated by the net asset value method. The difference in value between the controlling interest and minority interest levels of value is called a minority interest discount.

In addition to the indignities associated with lack of control, minority interests in asset-holding entities are rarely marketable. As a result, the fair market value of nonmarketable minority interests is typically reduced even further to compensate for the absence of ready marketability. Investors will pay less for an investment if the terms and timing of exit are uncertain than for the same investment if it is traded in an active market. This decrement is referred to as the marketability discount.

Although Revenue Ruling 59-60 is silent with respect to minority interest and marketability discounts, case law has recognized the reality and significance of these discounts in the valuation of minority interests in asset-holding entities. The valuation literature has traditionally proposed a conceptual view of these discounts by way of the levels of value framework.

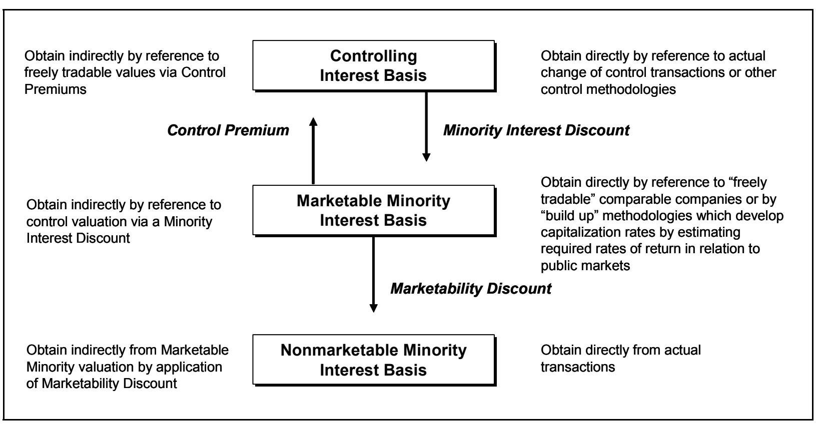

Figure 4 - 1

» *Controlling interest basis* refers to the value of the asset-holding entity as a whole. The controlling shareholder of an asset-holding entity has discretion with respect to composition of the underlying investment portfolio and the timing and manner of liquidation and distribution of the underlying assets.

» *Marketable minority interest basis* refers to the value of a minority interest that lacks discretion concerning management of the underlying investment portfolio, but does enjoy ready liquidity. In other words, while the owner of a marketable minority interest cannot control the operations of the asset-holding entity, the investor does have the ability to sell that interest into an active market, akin to the rights of a minority shareholder in a large public company.

» *Nonmarketable minority interest basis* refers to the value of a minority interest that lacks both control and marketability. As at the marketable minority interest level, these investors do not have the ability to direct the operations of the asset-holding entity. In addition, the owner of a nonmarketable minority interest does not enjoy ready liquidity. There is no active market into which a nonmarketable minority interest may be readily sold.

Minority Interest Discount

To obtain the value of an entity on a marketable minority interest basis, a minority interest discount is applied to the controlling interest basis indication of value. While the income and guideline company methods of valuation often used to value operating companies produce valuation indications that are already on a marketable minority interest basis, the net asset indication of value that is used for asset-holding entities provides a controlling interest basis indication of value. Therefore, the valuation of minority interests in asset-holding entities requires the application of a minority interest discount. Not surprisingly, given the lack of guidance in Rev. Rul. 59-60, there is often disagreement as to how the magnitude of the minority interest discount should be determined.

Analysis of publicly traded, closed-end equity and bond funds enables an analyst to obtain average and median indications of minority interest discounts based on the reported price to net asset value relationships of the closed-end funds. While closed-end equity and bond funds tend to indicate average discounts to net asset value in the 5%-10% range, individual funds can be priced at modest premiums or fairly steep discounts to net asset value, depending on the unique features of the funds. Although it is unlikely that any of the individual publicly traded funds is directly comparable to the subject entity, the average and median discounts for the group of funds represent a consensus marketplace indication of the value of a minority interest relative to an underlying portfolio of securities. Because indications of minority interest discounts are based on the market prices of the closed-end funds at the time of valuation, the size of the minority interest discount used in a recurring valuation of an asset-holding entity will not necessarily remain constant.

Another method for estimating minority interest discounts relies on listings of the market prices and net asset values of real estate investment trusts ("REITs"). While this method is theoretically similar to the analysis of closed-end funds mentioned above, data on the net asset values of REITs is only released annually, compared to the monthly data available for closed-end funds. Because the data, and thus the discount estimates, for REITs can become dated over the course of a year, relying on closed-end funds to estimate minority interest discounts is often considered to be more timely.

Marketability Discount

To move from the marketable minority interest value of an asset-holding entity to the nonmarketable minority interest value, a marketability discount is applied to the marketable minority interest value. Business appraisers rely on a variety of techniques for determining the size of the marketability discount. Assessing the relative merit of the alternative methodologies is a perennial source of controversy in the Tax Court and among appraisers. As with minority interest discounts, Rev. Rul. 59-60 provides little guidance with respect to marketability discounts.

Methods for estimating the marketability discount appropriate for a particular subject interest can generally be classified within either the market or income approaches. The valuation methods under the market approach are commonly referred to collectively as "benchmark analysis." The various forms of benchmark analysis consider data from 1) restricted stock transactions,

2) pre-IPO studies, and 3) decisions rendered in court cases. In our experience, the usefulness of a market approach to value a nonmarketable interest is limited by the quality and relevance of available market data. In the case of the most commonly cited restricted stock and pre-IPO studies, the unique facts and circumstances surrounding the observed discounts are unknown and/or unreported. Further, much of the data is quite dated, potentially undermining its relevance with respect to current market dynamics.

Most importantly, although observations in restricted stock and pre-IPO transactions are often distilled into a typical range of marketability discounts, analysis of the underlying data shows such a dispersion of individual observations that the ranges cannot be mechanically applied to a particular subject interest. The use of court decisions by the valuation profession has generally waned as courts have come to expect analysis based more on facts and circumstances specific to a given subject interest.

Since the mid-1990s, alternative methodologies have been developed to analyze the discount for lack of marketability within the income approach. These methods focus on determining the present value of the future benefits expected to accrue to the owner of a nonmarketable minority interest. One such method, the Quantitative Marketability Discount Model ("QMDM"), has been widely published by Mercer Capital. The QMDM is a shareholder-level discounted cash flow model based upon key groups of assumptions about expected benefits, each related to the specific facts and circumstances of the subject interest.

Despite debate among appraisers regarding the appropriate method(s) for determining marketability discounts, there is a broad consensus that four general factors contribute to the magnitude of the appropriate marketability discount. These factors, discussed in further detail below, are the expected holding period for the investment or time to liquidity, projected interim cash flows, growth in value during the holding period, and the required return from the investment.

Expected Holding Period

Without an active market, nonmarketable minority interests must be held for an uncertain length of time until an opportunity for liquidity materializes. In general, longer expected holding periods are associated with larger marketability discounts. In our experience, expected holding periods are generally a function of the following:

- Historical ownership policies (insiders, outsiders, family, investors, etc.)
- Buy-sell or other agreements
- Management/ownership succession (age, health, competence, emerging liquidity needs)
- Business plans and likely exit strategies of the controlling owner(s)
- Opportunities for the favorable sale of the underlying assets

When assessing the expected holding period for a particular interest, appraisers should consult management regarding any plans for dissolving the entity, selling any assets and distributing the proceeds to the shareholders, and whether any of the existing shareholders would be willing and able to purchase additional interests in the entity.

Common observation suggests that the probability of a business of any type passing successfully from the first generation to the second is fairly low, and that the probability of successful passage grows lower with each successive generation. In our experience, some event, whether ownership consolidation, recapitalization, dissolution, or the like, may create appealing exit opportunities for holders of nonmarketable minority interests over any 10 to 20 year period. In many cases, shorter holding periods may reasonably be anticipated, given the particular facts and circumstances.

Projected Interim Cash Flows

The relevant interim cash flows attributable to a nonmarketable minority interest are the dividends or distributions received by the owners of an asset-holding entity. Marketability discounts are generally considered to be inversely related to the expected level of dividends or distributions. Appraisers should evaluate expected dividends or distributions in the context of historical payout policy and the entity's ability to distribute cash. Appraisers should consider not only the current level of distributions (generally expressed as a yield), but also the rate at which distributions may grow over the expected holding period.

As discussed previously, many asset-holding entities are organized as tax pass-through entities. This election can distort the effective distribution yield of many asset-holding entities. Market rates of return for equity investments are generally based on the observed returns realized by shareholders of C corporations. C corporations pay taxes on their corporate earnings and pay dividends to shareholders, which are then taxable when received. Many of the asset-holding entities valued in accordance with Rev. Rul. 59-60 are structured to avoid this double taxation of earnings. Therefore, appraisers need to restate the dividend yield of a tax pass-through entity to make the resulting rates of return comparable to those observed in the market.

As an example of this restatement, consider ABC Ltd., a limited partnership that owns rental properties.

Marketable Minority Value of ABC Ltd.		$100,000
Taxable Income		$8,000
Shareholder Federal Taxes @	35.0%	$2,800
Distributions to Shareholders		$6,000
Economic Benefit to Shareholders		$3,200

Figure 4 - 2

As owners of a tax pass-through entity, the partners of ABC are liable for taxes on their respective pro rata share of the partnership's income at their personal tax rates, regardless of whether ABC elects to make any distribution to partners. In this example, the partners bear the legal obligation to pay $2,800 in federal taxes. Assuming the partnership distributes $6,000, the partners will, after payment of taxes, have $3,200 of net benefit on which no further federal taxes are due. If ABC were instead a C corporation, what dividend, subject to taxes, would provide its owners with the same economic benefit? Assuming a federal tax rate on dividends of 15%, one would divide the $3,200 after-tax benefit received by the partners by 85% (100%-15%) to determine the appropriately restated distribution yield.

Economic Benefit to Shareholders	$3,200
÷ 1-Federal Tax Rate on Dividends	85.0%
Before Tax C Corpation Dividend	$3,765
C Corporation Dividend Yield for ABC	3.8%

Figure 4 - 3

Growth in Value During the Holding Period

If an investment is appreciating, that growth will provide a portion of the realized return during the holding period. As with interim cash flows, growth and marketability discounts are negatively correlated. As the expected growth rate increases, discounts for lack of marketability decrease. The expected growth in value of asset-holding entities should be evaluated in the context of the current portfolio composition, any expected changes in the portfolio, and anticipated distribution policy.

Discount Rate

Nonmarketable minority interests are subject to risks that do not pertain to more marketable investment alternatives. To compensate for these incremental risks, investors expect a premium return in excess of that offered by more readily marketable alternatives.

Incremental risks common to asset-holding entities include uncertainties with respect to the duration of the expected holding period, uncertainties relating to interim cash flows, and the risks associated with the difficulty of monitoring the performance of such investments. The more significant these risks are judged to be, the greater the required return, and the larger the appropriate marketability discount.

For some time, Partnership Profiles has published an annual study of the relationship between price and net asset value for real estate oriented limited partnerships by examining actual transaction prices which occur on secondary markets. Many of these so-called publicly traded partnerships were organized in the 1980s when over $100 billion was invested in publicly registered limited partnerships sold through broker dealers. In the 1990s, several companies began to act as intermediaries, matching buy and sell offers so that disappointed investors (of whom there were many) could liquidate their holdings. Many of these sales have occurred at a loss to the original investment, and most have occurred at discounts to net asset value. This data can provide an important test of reasonableness for the overall discount (minority and marketability) from net asset value for real estate asset-holding entities.

CONCLUSION

In this chapter, we reviewed the valuation of asset-holding entities in the context of the guidance provided by Revenue Ruling 59-60. That guidance suggests that, in determining the fair market value of interests in asset-holding entities, appraisers should look to net asset value as the principal indication of value.

Net asset value reveals the value of a controlling interest in an asset-holding entity. Appraisers are often retained to determine the fair market value of nonmarketable minority interests, however. Unfortunately, Rev. Rul. 59-60 is more reticent when discussing the often quite significant minority interest and marketability discounts applied to derive nonmarketable minority interest values.

Minority interest discounts are often estimated by reference to the observed discounts to net asset value for closed-end mutual funds and real estate investment trusts near the valuation date. While there is less consensus with respect to the best means of estimating marketability discounts, most appraisers suggest that these discounts are related to, among other things, the expected holding period of the investment, interim cash flows, growth in value, and required return.

Chapter 5
The Growing Influence of Intangible Assets

Intangible assets are easy to overlook. After all, in a sense, they are not really there. Intangible assets are ultimately defined by their nothingness – they are assets that lack physical substance. Companies, large and small, public and private, invest in, and ignore, potentially valuable intangible assets every day.

In this chapter, we survey the relative significance of intangible assets to the overall value of companies in today's economy compared to 1959. Then we review and analyze what Revenue Ruling 59-60 has to say about the value of intangible assets. We also assess what makes intangible assets valuable. Finally, we consider some of the implications for valuing private companies.

THE SIGNIFICANCE OF INTANGIBLE ASSETS

In today's economy, a substantial portion of the total market value of the largest companies in the United States is attributable to the companies' intangible, rather than tangible, assets. Given the prominence of intangible assets, business appraisers need to thoroughly and carefully assess whether a given subject business benefits from the ownership of valuable intangible assets.

Guidance from the Financial Accounting Standards Board, or FASB, provides a helpful taxonomy for identifying and evaluating a company's intangible assets. In ASC 805, *Business Combinations* (formerly SFAS 141R), the FASB identifies five broad categories of identifiable intangible assets.

Category	Example Assets
Marketing-Related	Trademarks, internet domain names
Customer-Related	Customer relationships, order backlogs
Artistic-Related	Literary & musical works, video & audiovisual material
Contract-Based	Licensing & franchise agreements, permits and other rights
Technology-Based	Software, patented & unpatented technology

Figure 5 - 1

The categories in Figure 5-1 describe those intangible assets that can be specifically identified. The portion of the total value of a company that exceeds the value of its net tangible and identifiable intangible assets is known as goodwill. Goodwill is a residual amount, reflecting that portion of total enterprise value arising from the company's collection of assets.

REVENUE RULING 59-60 AND INTANGIBLE ASSETS

Among the eight factors to consider in determining the value of a closely held corporation enumerated in Section 4 of Revenue Ruling 59-60 is "[w]hether or not the enterprise has goodwill or other intangible value."

As with the other seven factors to consider, a subsequent section of the Ruling elaborates on the significance, and ultimate source, of intangible value in a company:

> 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 the 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. (Sec. 4.02 (f), as amended by Revenue Ruling 65-193)

Despite the fact that the value of intangible assets was not nearly as significant to companies in 1959 as it is today, the text provides solid guidance for appraisers and readers of appraisal reports assessing whether a business has valuable intangible assets, and if so, just how valuable they are. It is important to note that the references to goodwill in the excerpt above refer not only to the residual goodwill value, but also to the identifiable intangible assets of the business.

Assets are sometimes defined as probable future economic benefits. While intangible assets do not have physical substance, they must have economic substance in the form of contribution to a company's earning capacity. This contribution need not be direct (i.e., a direct source of revenue), but can be indirect (i.e., provide cost savings, or prevent the loss of business to competitors). If an intangible asset does not contribute to the subject company's current or future earnings capacity, it will not have any value.

The discussion in the Ruling also highlights the nature of the earnings that give rise to intangible asset value. In order to be valuable, an intangible asset must contribute to the generation of "excess" earnings. In other words, the presence of positive accounting earnings provides no assurance that a company owns valuable intangible assets. Rather, a company's earnings must first cover the opportunity costs associated with having capital tied up in tangible assets. Only after such opportunity costs are covered will a company have positive intangible asset value. This concept can also be addressed in terms of the company's cost of capital; unless the company has demonstrated the capacity to generate a return on tangible investment in excess of its cost of capital, it is unlikely to have valuable intangible assets.

Finally, the Ruling provides a (non-exhaustive) list of the sort of competitive advantages that may allow a business to generate so-called excess earnings. Frequently, the "prestige and renown" of a business allows the company to charge premium prices for its product or service relative to its competitors. Likewise for a tradename. A "record of successful operation over a prolonged period in a particular locality" suggests some cost advantage. Intangible assets that contribute to either superior pricing power or unique cost efficiencies are likely to contribute to the company's value.

As is always the case when discussing valuation, it is the *future* cash flows that matter, not those earned in the *past*. In other words, intangible value is ultimately a function not just of today's excess earning power, but also the rate at which that earning power is projected to grow into the future. Given two companies with identical excess earnings in the current period, the one with the higher expected growth rate will have greater intangible asset value.

ASSESSING THE VALUE OF INTANGIBLE ASSETS

Another way to discuss the value of intangible assets is in terms of sustainable competitive advantage. The classic framework for assessing industry dynamics and competitive advantage is Michael Porter's famous "five forces" (*Competitive Advantage: Creating and Sustaining Superior Performance,* Free Press, 1998). Briefly, the five forces are:

1) *Bargaining Power of Suppliers.* With respect to the company's production inputs, are there a handful of suppliers that can adjust prices to capture a portion of what would otherwise be excess earnings, or are there many potential sources of supply?

2) *Bargaining Power of Customers.* Similar to the supplier analysis, are there a small number of customers that can dictate pricing and terms for the company, or are customers effectively price takers? Companies with a large number of stable customers often have a superior ability to generate excess earnings compared to those with a single customer that accounts for a significant portion of revenues.

3) *Threat of New Entrants.* Are there meaningful barriers to entry (capital investment, technological know-how, regulatory approval) that limit competition, or is the market open for new entrants that are likely to squeeze margins in their own quest for excess earnings?

4) *Threat of Substitute Products.* Is there more than one way to skin the proverbial cat? Can the basic customer need be satisfied by alternative products? If so, the company's pricing power, and potential for excess earnings, is likely limited. If not, the company will be more likely to be able to charge a premium price and generate excess earnings.

5) *Threat of Established Rivals.* What is the state of competition in the industry? Are there many or few competitors? Is the industry growing or shrinking? Do competitors face high or low fixed costs? Intense competition within an industry is likely to reduce the ability to earn excess profits.

IMPLICATIONS FOR VALUING PRIVATE COMPANIES

What does the increasing significance of intangible assets mean for the valuation of private companies with the guidance of Revenue Ruling 59-60? In one sense, the burgeoning business appraisal profession owes its existence to the growth in intangible asset values. After all, in the absence of intangible assets, the value of a privately held business is simply the sum of the values of its tangible assets, net of liabilities. That leaves little room for a business appraiser to ply his trade. It is no coincidence that the business appraisal profession experienced significant growth at the same time that the value of intangible assets was becoming a much greater portion of the overall value of businesses.

We draw the following conclusions from this discussion of intangible asset value:

» *Intangible assets are real and valuable.* It is a mistake to assume that, since intangible assets lack physical substance, they also lack value. Intangible assets are real, and, as we have shown, a significant portion of the value of many businesses.

- *Intangible assets are valuable because they generate excess earnings.* Intangible assets are not valuable simply because they exist. A patent for a device that no one wants or needs is not valuable. On the contrary, intangible assets are valuable because they contribute to the company's earnings. Furthermore, the relevant earnings measure is not the reported earnings measured by accountants, but rather economic earnings, or those in excess of the expected return on net tangible assets.

- *Intangible assets contribute to excess earnings only because they provide sustainable competitive advantages.* A firm with no sustainable competitive advantages cannot generate excess earnings over the long term. If intangible assets are to have value, they must provide some sustainable competitive advantage to the owner, consisting of either the ability to charge premium prices or the enjoyment of some cost advantage.

Chapter 6
Selecting a Business Appraiser

Business appraisal is both an art and a science, and Revenue Ruling 59-60 reinforces this point upon a full reading of the complete document. The concepts of the willing buyer and the willing seller, as well as the basic eight factors to consider requiring careful analysis in each case, are broadly recognized. However, Revenue Ruling 59-60 needs to be properly recognized as setting forth the theory for the appraisal of closely held corporations, and appropriately highlights the difficulty in applying that theory in practice.

In Section 3, Approach to Valuation, the Ruling states:

> Often, an appraiser will find wide difference of opinion as to the fair market vale 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 judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.
>
> The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation that issued the stock, but that judgment must be related to all of then other factors affecting value.

In Section 6, Capitalization Rates, the Ruling goes on to say:

> A determination of the proper capitalization rate presents one of the most difficult problems in valuation.… Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated.

The thoughtful concepts of reasonableness, judgment, and consideration resonate throughout Revenue Ruling 59-60. Indeed, some form of the word "consider" appears approximately 31 times. The body of knowledge that allows for that thoughtful consideration can be found in the certifications and professional designations that relate to business valuation.

PROFESSIONAL CREDENTIALS

There are several credentials or professional designations that are applicable to business valuation and related subjects. Professional credentials include the following designations:

» *Accredited Senior Appraiser (ASA).* This designation is granted by the American Society of Appraisers ("ASA"). The American Society of Appraisers is a multi-disciplinary organization (including members in real estate, business valuation, fine arts, machinery and equipment and gemology), and the Accredited Senior Appraiser designation initially requires passing an ethics exam and a course and examination on the Uniform Standards of Professional Appraisal Practice. Once those two requirements are met, the applicant must pass or demonstrate acceptable equivalency for a series of principles of valuation courses. Upon successful completion of the courses, an individual must have a minimum of five years of full-time equivalent appraisal experience. Additionally, candidates must submit a representative appraisal report for review by the organization. (www.appraisers.org)

» *Accredited in Business Valuation (ABV).* This designation is granted by the American Institute of Certified Public Accountants ("AICPA"). The AICPA is the national professional association for Certified Public Accountants in the United States. The additional designation of ABV requires that members hold a valid CPA certificate, and pass a comprehensive business valuation examination. Also, substantial involvement in at least six business valuation engagements or evidence of 150 hours is required. (http://fvs.aicpa.org)

- *Certified Business Appraiser (CBA).* This designation is granted by the Institute of Business Appraisers ("IBA"). The CBA designation requires members to hold a 4-year college degree or equivalent, successfully complete at least 24 hours of coursework offered by the IBA, and complete a 6-hour, proctored, CBA written examination covering the theory and practice of business appraisal. In addition, designation candidates are required to submit two examples of their work to the IBA for review before being granted the designation. (www.go-iba.com)

- *Certified Valuation Analyst (CVA).* This designation is granted by the National Association of Certified Valuation Analysts ("NACVA"). The CVA designation requires the successful completion of a five-day Business Valuation and Certification course, a proctored exam, and a case study, and two years experience as a CPA. (www.navca.com)

- *Chartered Financial Analyst (CFA).* This designation is granted by the CFA Institute. To earn the CFA Charter, you must pass through the CFA Program, a graduate-level, self-study program that provides a broad curriculum with professional conduct requirements, culminating in a series of three sequential exams. The CFA program is not structured as an appraisal program. Rather, charter holders are typically employed as securities analysts, portfolio managers or investment bankers and consultants. The securities analyst approach to the body of knowledge includes ethical and professional standards, quantitative methods, economics, financial reporting and analysis, corporate finance, equity investments, fixed income analysis, derivatives, alternative investments and portfolio management and wealth planning. (www.cfainstitute.org)

- *Chartered Business Valuator (CBV).* This designation is granted by The Canadian Institute of Chartered Business Valuators ("CICBV"). In order to achieve the CBV designation, an individual must complete six courses offered by the CICBV, accumulate at least 1,500 hours of business and securities valuation work experience, and successfully pass the membership entrance exam. (www.cicbv.ca)

EXPERIENCE

Experience counts, and the professional credentialing requirements highlight that important aspect of training. However, while a five-year time-in-grade may be sufficient to grant a professional credential, long-term experience really shows up upon examination of the appraiser's depth and breadth of assignments undertaken. Experience is also evident in a more subtle way: the interaction of the appraiser with other professionals in his own firm. Since it is difficult to build a business appraisal practice around a limited number of industries, the larger appraisal firms provide the benefit of experience at the firm level, which helps ensure the necessary quality control.

Experience also counts in answering the question: Should we hire an industry expert for this engagement, or is it preferable to hire a valuation expert? Given valuation expertise and broad industry perspective, specific industry expertise provides an element of comfort. However, in most independent valuation situations, industry expertise alone is an inadequate level of qualification unless supplemented by valuation knowledge and breadth of industry experience.

THE TOP 5 THINGS AN ATTORNEY SHOULD KNOW WHEN SELECTING A BUSINESS APPRAISER

1) *Define the project.* In order for the appraiser to schedule the work, set the fee, and understand the client's specific needs, the attorney needs to provide some basic benchmark information, such as: a description of the specific ownership interest to be appraised (number of shares, units, bonds); an understanding of the level of value for the interest being appraised; a specification of the valuation date, which may be current, or may be a specific historical date; a description of the purpose of the appraisal (informing the appraiser why the client needs an appraisal and how the report will be used).

2) *Insist on an appraiser with experience and credentials.* Each business appraisal is unique and experience counts. Most business valuation firms are generalists rather than industry specialists, but the experience gained in discussing operating results and industry

constraints with a broad client base gives the appraisal firm substantial ability to understand the client's special situation. Credentials do not guarantee performance, but they do indicate a level of professionalism for having achieved and maintained them. Attorneys should insist upon them.

3) *Involve the appraiser early on.* Even in straightforward buy-sell agreements, family limited partnerships, or corporate reorganizations, it is helpful to seek the advice of the appraiser *before* the deal is set, to see if there are key elements of the contract document that could be modified to provide a more meaningful appraisal to the client.

4) *Ensure that your expert's report can withstand a Daubert challenge.* In *Daubert* (*Daubert v. Merrell Dow Pharmaceuticals, Inc.* 113 S.Ct. 2786 (1993)), the Supreme Court noted several factors that might be considered by trial judges when faced with a proffer of expert (scientific) testimony. Several factors were mentioned in *Daubert* which can assist triers of fact in determining the admissibility of evidence under Rule 702, including:

    a) Whether the theory or technique in question can be (and has been) tested

    b) Whether it has been subjected to peer review and publication

    c) The known or potential error rate of the method or technique

    d) The existence and maintenance of standards controlling its operation

    e) The underlying question: Is the method generally accepted in the technical community?

5) *Expect the best.* In most cases, the fee for appraisal services is nominal compared to the dollars at risk. The marginal cost of getting the best is negligible. Attorneys can help their appraiser do the best job possible by ensuring full disclosure and expecting an independent opinion of value. The best appraisers have the experience and credentials described above, but recognize the delicate balance between art and science that enables them to interpret the qualitative responses to due-

diligence interviews and put them in a stylized format that quantifies the results.

THE TOP 3 THINGS A BUSINESS OWNER SHOULD KNOW WHEN SELECTING A BUSINESS APPRAISER

1) *Understand the levels of value.* There is no such thing as "the value" of a closely held business. That is an implicit assumption in the field of business appraisal. Yet, business appraisers are engaged to develop a reasonable range of value for client companies. Confusion over an appraiser's basis of value, either by appraisers or by users of appraisal reports, can lead to the placing of inappropriately high or low values on a subject equity interest. The unfortunate result of such errors can include the overpayment of estate taxes, contested estate tax returns, and ESOP transactions that prove uneconomical or unlawful. Therefore, it is essential that both business appraisers and the parties using appraisals be aware of the correct basis of value and that appropriate methodologies be followed in deriving the conclusion of value for any interest being appraised.

   The levels of value chart is a conceptual model used by many appraisers to describe the complexities of behavior of individuals and businesses in the process of buying and selling businesses and business interests. It attempts to cut through the detailed maze of facts that give rise to each individual transaction involving a particular business interest and to describe, generally, the valuation relationships that seem to emerge from observing thousands upon thousands of individual transactions.

Valuation theory suggests that there are three levels of value applicable to a business or business ownership interest:

» *Controlling interest basis* refers to the value of the enterprise as a whole

» *Marketable minority interest basis* refers to the value of a minority interest, lacking control, but enjoying the benefit of liquidity as if it were freely tradable in an active market

» *Nonmarketable minority interest basis* refers to the value of a minority interest, lacking both control and market liquidity

The relationship between these three levels of value is depicted in Figure 6-1.

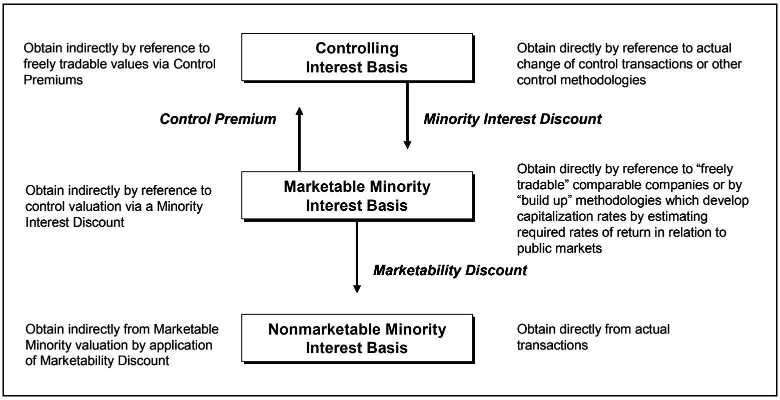

Figure 6 - 1

Levels of value can co-exist, with one shareholder owning a controlling interest, one a marketable minority interest, and one a nonmarketable minority interest. Clearly, the appropriate level of value depends upon the purpose of the valuation. Nevertheless, understanding the three primary levels of value is critical to the valuation process both from the standpoint of the appraiser and the client.

2) *Understand the difference between your compensation rate of return and your investment rate of return.* Business owners will often combine these two concepts into one return, typically in the form of compensation. Since it all comes from the same pot (the company), why does this matter? Your business appraiser will help you segregate these two concepts, since the appraisal will be dependent upon a proper investment rate of return, *after* consideration of a proper compensation rate of return (i.e., compensation expense). The business owner/operator is due both returns, but there is a clear distinction between the two.

3) *The business appraiser is not your advocate.* Your attorney is your advocate, and your appraiser must be independent of the consequences of the conclusion of value. If litigated, opposing counsel is certain to ask the appraiser if he received any guidance with regard to a suggested conclusion or range of values that was expected.

THE TOP 3 THINGS AN ACCOUNTANT SHOULD KNOW WHEN SELECTING A BUSINESS APPRAISER

1) *Avoid the conflict of interest trap.* Your tax and audit clients will appreciate the fact that you consider your relationship too important to jeopardize by performing a business valuation that almost certainly would be challenged as having at least a perceived conflict of interest. The one-time appraisal assignment will be thought of as a relatively minor fee-income generating project in context with on-going annual tax and audit work. Locate an independent business appraiser with whom you can work, and you will feel comfortable in providing a referral to a professional who does not also provide the tax and audit services.

2) *Avoid the lack of experience trap.* Business appraisals have become increasingly detailed and sophisticated as the profession has grown. Accounting firms typically build their book of business on tax and audit work. If your internal staff does not include professionals dedicated solely to business valuation, the part-time nature of

generating marginal additional fees by business appraisal may come back to haunt you and your client, typically in court.

3) *Help your client distinguish between a business appraisal and a real estate appraisal.* Many of the corporate entities appraised either own or rent the real estate where the business is operated. For a successful operating business, the most meaningful valuation is typically based on some measure of capitalized earnings, rather than the value of the underlying real estate. However, the accountant will recognize that some businesses, due to the nature of their operations, are characterized more by their underlying assets, and less so by their earnings power. This is true for asset-holding entities, and for some older family businesses with marginal earnings but with appreciated real estate on the books. Many business appraisers are not asset appraisers, but may need to consider a qualified real estate appraisal in the business valuation process.

Chapter 7
Landmark Tax Court Cases

By L. Paul Hood, Jr.

The basic principles that are embodied in Rev. Rul. 59-60 have been around for a lot longer than the ruling itself. Rev. Rul. 54-77 (1954-1 C.B. 187) preceded Rev. Rul. 59-60, and Rev. Rul. 59-60 superseded Rev. Rul. 54-77. The "basic eight factors" set out in the two rulings actually are contained in Treas. Reg. Sec. 20.2031-2(f), which actually was promulgated in 1958, i.e., after the issuance of Rev. Rul. 54-77.

SUBSEQUENT MODIFICATIONS OF REVENUE RULING 59-60

When issued originally, Rev. Rul. 59-60 only applied to valuations of closely held corporations for estate and gift tax purposes. The United States Department of the Treasury has modified Rev. Rul. 59-60 with additional revenue rulings over the years. The first ruling, Rev. Rul. 65-192 (1965-2 C.B. 259), extended Rev. Rul. 59-60 to valuations of interests in all other entities as well as to valuations of intangible assets for all tax purposes. Rev. Rul. 65-193 (1965-2 C.B. 370) modified Rev. Rul. 59-60 to eliminate the last sentence of Sec. 4.02(f) in Rev. Rul. 59-60, which was not included in Rev. Rul. 54-77, concerning the appraisal of goodwill. Rev. Rul. 77-287 (1977-2 C.B. 319) amplified Rev. Rul. 59-60 to cover valuations of restricted stock. Rev. Rul. 80-213 (1980-2 C.B. 101) further amplified Rev. Rul. 59-60 to pertain to stapled stock. Rev. Rul. 83-120 (1983-2 C.B. 170) further amplified Rev. Rul. 59-60 to deal with valuation of preferred stock.

COMPARISON OF REVENUE RULINGS 54-77 AND 59-60

It is useful to compare the two rulings, particularly as to what language in Rev. Rul. 54-77 was excluded in Rev. Rul. 59-60, and what Rev. Rul. 59-60 contains that was not included in Rev. Rul. 54-77. However, by way of comparison, the two rulings are very similar in most respects. Each ruling has the same eight substantive sections, which are arranged in the exact same order: purpose, background and definitions, approach to valuation, factors to consider (the "basic eight factors" which are often are set out in judicial opinions. See, e.g., *Estate of Simplot v. Comr.*, 112 T.C. 130 (1999)), weight to be accorded various factors, capitalization rates, average of factors and restrictive agreements. Importantly, Section 3 in both rulings contains the "critical three factors" of valuation: common sense, informed judgment, and reasonableness. That same section warns all that "valuation is not an exact science."

There are three major differences between the two rulings: two where Rev. Rul. 59-60 contains language that was not included in Rev. Rul. 54-77, and one where language in Rev. Rul. 54-77 was not included in Rev. Rul. 59-60.

Rev. Rul. 54-77 contained the following language concerning similarity of guideline companies that was not included in Rev. Rul. 59-60:

> The test should be for similarity not only of the type of business but of the trend of earnings, capital structure, volume of sales, and size in terms of total assets, as well, in order that the most valid comparison possible will be obtained.

The omitted language provides factors for determining comparability, but perhaps it was too tight a test of comparability. Sec. 4.02(h) of Rev. Rul. 59-60 provides the only description of comparability, that being "other relevant factors," which is broader than the omitted language above. Sec. 4.02(h) provides three examples of "other relevant factors," including capital structure, trend in earnings and trend in markets, two of which were expressly included in the omitted language.

Unlike Rev. Rul. 54-77, Sec. 4.02(h) of Rev. Rul. 59-60 makes it clear that guideline companies must "have capital stocks which are actively traded by the public." It remains unclear how this language impacts upon the use of private company databases in the application of a guideline merged company valuation technique for federal tax valuation purposes.

Rev. Rul. 59-60 also contains Sec. 3.03, which begins by explaining that valuation "is, in essence, a prophesy as to the future and must be based on facts *available* at the required date of appraisal." [*emphasis* added] Sec. 3.03 goes on to provide that, as a general proposition, the market "prices of stocks which are traded in a free and active market by informed persons best reflect the consensus of the investing public." (Sec. 3.03 of Rev. Rul. 59-60 has been quoted in several judicial decisions, including *Polack v. Comr.*, 366 F. 3d 608, 611 (8th Cir. 2004), aff'g, T.C. Memo 2002-145. See also *Estate of Noble v. Comr.*, T.C. Memo 2005-2).

Sec. 3.03 points out that the closely held or infrequently traded stock requires another measure of price since there is no materially significant market for such interests. The section concludes with an observation that is applicable in many such situations: the use of "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."

Rev. Rul. 54-77 has only been cited once by the Tax Court in reported decisions: *Estate of Heinold v. Comr.* (T.C. Memo 1965-6). Although the Tax Court did not discuss Rev. Rul. 54-77 in that decision, it also referenced Rev. Rul. 59-60 without discussion. However, the Third Circuit cited Rev. Rul. 54-77 in a footnote in *Estate of Levenson v. Comr.* (282 F. 2d 581 (3d Cir. 1960)). The Eighth Circuit quoted the basic eight factors of Rev. Rul. 54-77 in *Estate of Fitts v. Comr.* (237 F. 2d 729 (8th Cir. 1956)). The Third Circuit also quoted the basic eight factors in *U.S. v. Alker* (260 F. 2d 135 (3d Cir. 1958)).

THE COURTS AND REVENUE RULING 59-60 GENERALLY

Courts frequently cite Rev. Rul. 59-60 or they clearly go along with it as the accepted valuation guidance, even though it is only a revenue ruling (See, e.g., *Estate of Jelke*, 507 F. 3d 1317 (11th Cir. 2007)). The U.S. Supreme Court has held that revenue rulings are only entitled to deference from courts, which are not bound by them (*Skidmore v. Swift & Co.*, 323 U.S. 134 (1944); *Chevron U.S.A, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). See also *Stark v. Comr.*, 86 T.C. 243 (1986) and *Estate of Ford v. Comr.*, T.C. Memo 1993-580, aff'd 53 F. 3d 924 (8th Cir. 1995)).

Prior to 1970, the courts did not cite Rev. Rul. 59-60 that often (fewer than ten reported decisions), and no case prior to 1970 discusses Rev. Rul. 59-60 in any depth other than a mere reference. The courts picked up the pace after 1970, and they began to discuss the ruling in their decisions. One of the first decisions to actually discuss a specific section of Rev. Rul. 59-60 was *Estate of Dooly v. Comr.* (T.C. Memo 1972-164). In that case, the Tax Court observed that the IRS's sole reliance upon Sec. 5(b), which pertains to personal holding companies and entities that hold investment assets, was misplaced. In *Williams v. Comr*. (T.C. Memo 1973-154), the Tax Court agreed with Sec. 5(a) of Rev. Rul. 59-60 that the capitalization of income method was the primary concern in the valuation of the subject company (see also *Estate of Kirkpatrick v. Comr*., (T.C. Memo 1975-344), *Northern Trust v. Comr*., 87 T.C. 349 (1986) and *Estate of Huntsman v. Comr*., 66 T.C. 861 (1976), acq. 1977-2 C.B. 1.).

The Tax Court frequently cites its decision in *Estate of Newhouse v. Comr.* (94 T.C. 193 (1990)) for the proposition that Rev. Rul. 59-60 is the starting point and principal guidance for valuations of privately held or infrequently traded securities. From time to time, the courts have used Rev. Rul. 59-60 to make decisions. For example, in *Borgatello v. Comr*. (T.C. Memo 2000-64), the Tax Court determined that the conclusions of the taxpayer's appraiser expert in increasing the valuation discount based upon cash flow and ability to pay dividends were inconsistent with Rev. Rul. 59-60. In *Estate of Ford v. Comr*. (T.C. Memo 1993-580, aff'd., 53 F. 3d 924 (8th Cir. 1995)), the Tax Court determined that the taxpayer's appraiser had failed to consider Rev. Rul. 59-60. On appeal, the Eighth Circuit expressly ruled that the Tax Court had properly evaluated the basic eight factors of Rev. Rul. 59-60. In *Estate of Ford*, *supra*, the Tax Court had called down the taxpayer's appraiser for failing to explain why he did not consider all of the basic eight factors of Rev. Rul. 59-60.

However, in *Rabenhorst v. Comr*. (T.C. Memo 1996-92), the Tax Court was not sympathetic with an argument by the taxpayer, who was trying to disavow the work of the taxpayer's appraiser, that the appraiser had failed to consider Rev. Rul. 59-60. The Tax Court also called down the taxpayer's appraiser for believing that Rev. Rul. 59-60 required the share price to be determined by comparison to publicly traded companies. In *Estate of Luton v. Comr.* (T.C. Memo 1994-539), the IRS attempted to assert Rev. Rul. 59-60 to disregard the work of the taxpayer's appraiser because the appraiser had failed to find a guideline company, but the Tax Court disagreed. In *Estate of Gilford v. Comr.* (88 T.C. 38 (1987)), the Tax Court rebuked the IRS for asserting a position that the Tax Court felt was contrary to Rev. Rul. 59-60.

The Tax Court has substituted its own judgment of the proper weighting of the basic eight factors. For example, in *Moore v. Comr*. (T.C. Memo 1991-546), the Tax Court simply disagreed with many of the taxpayer's expert's weightings and considerations of the factors set out in Rev. Rul. 59-60.

The courts have disagreed from time to time about the effectiveness of the assistance of Rev. Rul. 59-60. In *Estate of Tully v. U.S*. (78-1 U.S.T.C. ¶ 13,228 (Cl.Ct. 1978)), the Claims Court called Rev. Rul. 59-60 the "most definitive guidelines" for valuation, while in *Estate of Thalmeier v. Comr*. (T.C. Memo 1974-203), the Tax Court observed that Rev. Rul. 59-60 provided nothing more than "generalized guidelines." Nevertheless, a federal district court made an in-depth analysis of the basic eight factors of Rev. Rul. 59-60 in *Estate of Doelle by Doelle v. U.S.* (78-2 U.S.T.C. ¶ 9480 (E.D. Mich. 1978)) and found that the IRS's appraiser had not used Rev. Rul. 59-60. In *Estate of Murphy v. Comr.* (T.C. Memo 1990-472), the Tax Court referred to the basic eight factors as being non-exclusive.

The Tax Court is human, too, and is capable of misinterpreting Rev. Rul. 59-60. In *Caracci v. Comr.* (456 F. 3d 444 (5th Cir. 2006), rev'g, 118 T.C. 379 (2002)), the Fifth Circuit found that the Tax Court had gone contrary to Rev. Rul. 59-60 by failing to assign a zero value to unprofitable intangible assets. In *Goodall v. Comr*. (391 F. 2d 775 (8th Cir. 1968), rev'g and rem'g T.C. Memo 1965-154), the Eighth Circuit reversed and remanded the case to the Tax Court because the Tax Court had applied a rigid fixed formula for evaluating the basic eight factors.

Rev. Rul. 59-60 describes the three basic valuation approaches: asset (cost), income, and market. In *Estate of Ford, supra*, the Tax Court held that Rev. Rul. 59-60 does not require a market (guideline) valuation. However, an appraiser has to use caution when not employing all three basic valuation approaches. In *Estate of Bennett v. Comr*. (T.C. Memo 1993-34), the Tax Court chastised the taxpayer's appraiser for solely relying upon the asset accumulation approach. For a case where the Tax Court criticized the IRS's appraiser for making the same mistake, see *Estate of Campbell v. Comr*. (T.C. Memo 1991-615). In *Estate of Smith v. Comr*. (T.C. Memo 1999-368), the IRS's appraiser selected guideline companies that were much larger than the subject company on the rationale that Rev. Rul. 59-60 forced him to do a market approach and precluded a size adjustment. The Tax Court rejected these positions. The Tax Court blessed the use of an asset approach in *Estate of Jameson v. Comr.* (T.C. Memo 1999-43).

Sec. 4.02(e) of Rev. Rul, 59-60 literally states that appraisers must consider the dividend-paying capacity of the subject company, but goes on to caution that dividends paid are less reliable criteria than other factors. In *Martin Ice Cream Co. v. Comr*. (110 T.C. 189 (1998)), the Tax Court ruled that the taxpayer's appraiser had "disregarded an explicit instruction" of Sec. 4.02(e) in that he had assigned a zero value to the dividend-paying capability of the taxpayer based upon the *Bardahl* formula (*Bardahl Mfr. Co. v. Comr*., (T.C. Memo 1965-200)), which he had determined was 30% of the corporation's value in his relative weightings.

In *Eyler v. Comr.* (T.C. Memo 1995-123), the taxpayer's appraiser based a significant part of his appraisal upon the first of the basic eight factors, the local economic condition factor, and the Tax Court agreed. The Tax Court reminded the IRS's appraiser of the warning contained in Rev. Rul. 59-60 about near exclusive reliance upon earnings and cash flow in *Estate of Mueller v. Comr*. (T.C. Memo 1992-284).

The taxpayer attempted to argue that the IRS's appraiser had employed a valuation formula in contravention of Sec. 7 of Rev. Rul. 59-60 in *Estate of Jann v. Comr*. (T.C. Memo 1990-3), but the Tax Court disagreed. The Tax Court also observed that the taxpayer's expert listed the basic eight factors in his appraisal report but failed to apply them. In *Estate of Obering v. Comr*. (T.C. Memo 1984-407), the Tax Court cited the warning in Sec. 7 of Rev. Rul. 59-60 about solely relying on the average of several factors. In *Martin Ice Cream v. Comr., supra*, the Tax Court also noted that the taxpayer's appraiser had disregarded the admonition of Sec. 7 of Rev. Rul. 59-60 that no useful purpose is served by averaging several of the factors and basing the result purely on that mathematical average.

In *Estate of Caplan v. Comr.* (T.C. Memo 1974-39), the Tax Court invoked Sec. 8 of Rev. Rul. 59-60 to determine that the price stipulated pursuant to an option to purchase via a buy-sell agreement was to have little effect on fair market value because the stockholder was free to dispose of the subject shares during lifetime. In *Estate of True v. Comr.* (T.C. Memo 2001-167), the Tax Court found that the taxpayer's appraiser had failed to follow Sec. 8 of Rev. Rul. 59-60 by considering a buy-sell agreement price as solely determinative of fair market value instead of as merely one of the factors affecting valuation.

The Tax Court has been the most active in interpreting Rev. Rul. 59-60. In *Estate of Gilford v. Comr*. (88 T.C. 38 (1987)), the Tax Court employed Rev. Rul. 59-60 to rule that only information available as of the valuation date was to be used in the valuation. In *Capital City Excavation v. Comr.* (T.C. Memo 1984-193), the Tax Court noted that Rev. Rul. 59-60 prefers listed stocks as guideline companies. In *Estate of McTighe v. Comr*. (T.C. Memo 1977-410), the Tax Court used Rev. Rul. 59-60 to support its opinion that, at that time, there should be no valuation discount for taxes on built-in capital gains. In *Estate of Grootemaat v. Comr.* (T.C. Memo 1979-49), the Tax Court held that a valuation discount for sales commissions was inconsistent with Rev. Rul. 59-60. In *Estate of Magnin v. Comr.* (T.C. Memo 2001-31), the Tax Court employed Rev. Rul. 59-60 to value a subject company prior to the date that even Rev. Rul. 54-77 was issued. In *Gross v. Comr*. (276 F. 3d 333 (6th Cir. 2002)), the Sixth Circuit noted that Rev. Rul. 59-60 did not prohibit tax-affecting.

THE COURTS AND THE BASIC EIGHT FACTORS

The cases are a bit difficult to track when it comes to the basic eight factors because Rev. Rul. 59-60 is not always mentioned with the discussion and the fact that those factors also are in the regulations. Nevertheless, the courts do review the factors and use them in their valuation determinations.

Nature and History of the Business

Many decisions begin with a discussion of the nature and history of the subject company. In *Estate of Giselman v. Comr*. (T.C. Memo 1988-391), the Tax Court analyzed the nature of the subject company's business, hardwood flooring installation, in order to determine that the company was in a cyclical business. In *Kohler v. Comr*. (T.C. Memo 2006-152), the Tax Court observed that both of the taxpayer's experts had provided extensive analysis of the nature of the business of the subject company. In *Estate of Dunn v. Comr*. (T.C. Memo 2000-12), the Tax Court noted that it expressly considered the nature of the business of the subject company in its analysis. In *BTR Dunlop Holdings, Inc. v.*

Comr. (T.C. Memo 1999-377), the Tax Court rejected the attempt by the taxpayer's appraiser to add a company-specific risk premium to a build-up method based on the subject company's risks to remain competitive in the automotive industry in the U.K. In *Estate of Feldmar v. Comr*. (T.C. Memo 1988-429), the Tax Court attributed more weight to earnings in a later year due to the presence of a historical downward trend in the profitability of the subject company, which was an insurance company.

Economic Outlook

The national and industry economic results and projections played a significant role that was beneficial to the taxpayer in *Estate of Newhouse v. Comr*. (94 T.C. 193 (1990), nonacq., 1991-1 C.B. 1). In that case, the Tax Court took note of the substantial amount of economic evidence of both the recent past and the economic projections for the future for the newspaper industry. In *Eyler v. Comr*. (T.C. Memo 1995-123, aff'd. 88 F. 3d 445 (7th Cir. 1996)), the Tax Court described the stark economic reality for the subject company's IPO attempt and worked that into its valuation of the taxpayer's stock in the subject company. In *Estate of Rodgers v. Comr*. (T.C. Memo 1999-129), the adverse local real estate market played a significant role in the taxpayer's victory in the valuation of shares in a real estate holding company. In *Okerlund v. U.S*. (53 Cl. Ct. 341 (2002)), the IRS appraiser attempted to argue that the subject company's good economic performance was one of the factors that indicated a lower discount for lack of marketability, but the Claims Court rejected this notion on the basis that the subject company's good economic outlook had already been accounted for in the pricing multiples that were applied to its earnings. In *Estate of Dunn v. Comr*. (T.C. Memo 2000-12, rev'd 507 F. 3d 1317 (11th Cir. 2007)), the Tax Court expressly factored economic outlook into its allocation of weights between the applicable valuation approaches. In *Estate of Brookshire v. Comr*. (T.C. Memo 1998-365), the Tax Court was of the opinion that the estate's appraisers had properly factored in not only the national economy but also the economy for the grocery store industry in the geographic region in which the subject company operated grocery stores. In *Estate of Ford*, *supra*, the Tax Court observed that the IRS's appraiser had properly considered the general economic condition as well as the condition of the industry.

Book Value and Financial Condition

Rev. Rul. 59-60 makes it clear that appraisers are supposed to look at multiple years of financial statements in order to get a feel for the trend in which the subject company's finances are headed. In *Estate of Bennett v. Comr*. (T.C. Memo 1993-34), the Tax Court stated that Rev. Rul. 59-60 requires analysis of the financial statements for more than one fiscal period. It is very rare today that plain book value plays much of a role in the valuation of closely held entities, although for holding companies, adjusted book value can play a significant role in the valuation (see, e.g., *Estate of Lee v. Comr*., 69 T.C. 860 (1978), acq., Rev. Rul. 93-12, 1993-1 C.B. 202). Historical book value plays very little role in valuation today in the eyes of most courts (see, e.g., *Estate of Andrews v. Comr*., 79 T.C. 938 (1982)).

Earning Capacity

In *Estate of Bennett*, *supra*, the Tax Court entertained the opinion of the taxpayer's appraiser, who based his appraisal in substantial part on the earning capacity of the subject company. In *Estate of Mueller v. Comr*. (T.C. Memo 1992-284), the Tax Court criticized the IRS's appraiser for only considering the subject company's "good years" in its evaluation of the company's earning capacity, citing Rev. Rul. 59-60 Sec. 4.02(d).

Dividend-Paying Capacity

In *Estate of Kohler v. Comr*. (T.C. Memo 2006-152), the Tax Court criticized the IRS's appraiser for not considering the dividend-paying capacity of the subject company since that company paid regular dividends and that was how a minority shareholder would likely get returns on his investment. In *Estate of Thompson v. Comr*. (T.C. Memo 2004-174, aff'd 499 F. 3d 129 (2d Cir. 2007)), the Tax Court determined that a 30% discount for lack of marketability was sufficient in part because the subject company paid regular, significant dividends. The Tax Court placed a significant emphasis on a price-to-dividends ratio in *Estate of Smith v. Comr*. (T.C. Memo 1999-368). In *Dockery v. Comr*. (T.C. Memo 1998-114), the Tax Court blessed a dividends-paid capitalization in order to determine value. The Tax Court agreed with the taxpayer's expert's allocation of 30% to the subject company's dividend-paying capacity in *Martin Ice Cream Company v. Comr*. (110 T.C. 189 (1998)). In *Mandelbaum v. Comr*. (T.C. Memo 1995-295), the Tax Court utilized dividend-paying capacity as one of the factors in determining a discount for lack of marketability. In *Estate of Newhouse v. Comr.* (94 T.C. 193 (1990)), the Tax Court agreed with the taxpayer's appraiser that the dividends that were actually being paid would significantly affect the value of the decedent's stock. In *Estate of Gillet v. Comr*. (T.C. Memo 1985-394), the Tax Court criticized two of the appraisers for failing to consider the dividend-paying capacity of the subject company.

Goodwill and Intangibles

In *Hess v. Comr*. (T.C. Memo 2003-251), the Tax Court determined that the subject company had a substantial amount of value in goodwill. In *Derby v. Comr*. (T.C. Memo 2008-45), the Tax Court found that pursuant to Rev. Rul. 59-60, a willing buyer would have insisted on a large discount on the intangible value of the subject company, a medical practice, in order to reflect that none of the doctor-employees had executed non-compete agreements.

Sales of Stock and the Size of the Block of Stock to be Valued

In *Litwin v. U.S*. (78 Fed. Cl. 90 (2007)), the Claims Court noted that each expert had to consider the fact that the subject block of stock was larger than the publicly offered block of stock of the subject company. In *Estate of Noble v. Comr*. (T.C. Memo 2005-2), the Tax Court disregarded three sales that were close to the valuation date as not being indicative of the stock's value as of that date. In *Estate of Borgatello v. Comr*. (T.C. Memo 2000-264), the estate attempted to argue that the estate would have to sell the 82.76% block of stock to two persons to ensure that all of it would be sold. Otherwise, the estate argued, the purchaser would only acquire enough stock to obtain majority control. Citing Rev. Rul. 59-60 and the willing buyer/willing seller principle, the Tax Court disagreed. In *Estate of Jung v. Comr*. (T.C. Memo 1990-5), the Tax Court ruled that evidence of the sale of the subject company after the valuation date was admissible where the underlying issue was the value of the decedent's stock in the subject company. Likewise, in *Estate of Obering v. Comr*. (T.C. Memo 1984-407), the Tax Court ruled that evidence of offers to buy the assets of the subject company was relevant in the determination of the value of the decedent's stock in that company. In *Morrisey v. Comr*. (245 F. 3d 1145 (9th Cir. 2001), rev'g *Estate of Kaufman v. Comr*., (T.C. Memo 1999-119)), the Tax Court refused to consider two apparently arm's length sales as indicative of value because of a difference in the size of the sold blocks of stock in comparison to the decedent's stockholdings, but the Ninth Circuit reversed on this point, finding the sales, which were based upon a Merrill Lynch appraisal, were arm's length sales. In *Estate of Green v. Comr*. (T.C. Memo 2003-348), the estate's appraiser relied in part upon seven sales of stock of the subject company, but six of them were consummated more than three years prior to the valuation date. Additionally, the estate's appraiser failed to include any information about the sales, such that the Tax Court could not determine whether those sales had been conducted at arm's length. In *Huber v. Comr*. (T.C. Memo 2006-96), the Tax Court accepted as sales at arm's length over 90 stock transactions between distant relatives that occurred at a price as determined by an annual Ernst & Young appraisal less 5%.

Market Prices of Guideline Companies

In *Estate of Hall v. Comr*. (92 T.C. 312 (1989)), the Tax Court held that the use of just one guideline (comparable) company was insufficient. The Tax Court ruled similarly in *Estate of Heck v. Comr*. (T.C. Memo 2002-34), where the IRS's appraiser named two guideline companies, but actually only used one of them in his guideline approach. In *Rabenhorst v. Comr*. (T.C. Memo 1996-92), the Tax Court rejected the taxpayer's appraiser's guideline companies as all being too dissimilar to the subject company. In *Estate of Neff v. Comr*. (T.C. Memo 1989-278), the Tax Court considered the price/earnings ratios of ten different guideline companies and also analyzed other factors such as the balance sheets of the guideline companies and pre-tax margins. However, the number of factors that an appraiser uses in his guideline company analysis can be critical. In *Estate of Gillet v. Comr*. (T.C. Memo 1985-394), the Tax Court wholly rejected an analysis by an appraiser who only looked at cash flow, earnings, and stock price to the exclusion of other factors that the Tax Court determined were relevant.

WEIGHT ACCORDED THE VARIOUS VALUATION METHODS AND FACTORS

Sec. 5 of Rev. Rul. 59-60 provides guidance as to the weight to be accorded the various valuation factors and methods. This section states that the weight to be accorded the various factors need not be equal in each case. Most of the cases that have referenced Sec. 5 have done so in the context of whether the earnings or the net asset value should be given primary emphasis. In *Estate of Campbell v. Comr*. (T.C. Memo 1991-615), the parties disagreed over whether the subject company was primarily an operating company or an investment company. The Tax Court observed that while the subject company possessed attributes of both, it ultimately decided to put the most emphasis on the net asset value indication. In *Estate of Ford v. Comr*. (T.C. Memo 1993-580, aff'd., 53 F. 3d 924 (8th Cir. 1995)), the Tax Court determined that the subject company was more of an investment company. In *Estate of Kelly v. Comr*. (T.C. Memo 2005-235), the Tax Court found that the net asset value was to be accorded the greatest weight. In *Estate of Blount v. Comr*. (T.C. Memo 2004-116), the Tax Court agreed with the IRS's appraiser that the greatest weight was to be given to the net asset approach. In *Estate of Deputy v. Comr*. (T.C. Memo 2003-176), the estate's appraiser relied solely upon a net asset approach, while the IRS's appraiser relied solely upon an income approach. The Tax Court sided with the IRS's appraiser. In *Estate of Dunn v. Comr*. (301 F. 3d 339 (5th Cir. 2002)), the Fifth Circuit assigned an 85% weight to an income approach and a 15% weight to an asset approach.

CAPITALIZATION RATES

Sec. 6 of Rev. Rul. 59-60 advises relative to capitalization rates. In *Estate of Deputy v. Comr.* (T.C. Memo 2003-176), the Tax Court had to evaluate the selected capitalization rates, over which the appraisers differed. Both appraisers utilized a build-up method to calculate the appropriate capitalization rate, but the experts differed as to whether a company/industry discount or premium should be added. In siding with the IRS's appraiser, the Tax Court determined that the estate's appraiser had not supplied sufficiently reliable data or even enough data to support his position, with each appraiser factoring in a small stock premium. In *Estate of Renier v. Comr*. (T.C. Memo

2000-298), the appraisers largely agreed on the appropriate capitalization rate on equity, which were each based on Ibbotson data. In *Furman v. Comr*. (T.C. Memo 1998-157), the Tax Court rejected the taxpayer's appraiser's capitalization rate, presumably on the grounds that he had understated the growth rate of the subject company. In *Estate of Klauss v. Comr*. (T.C. Memo 2000-191), the estate's appraiser added a small stock premium to his build-up capitalization rate, and the Tax Court agreed, rejecting the IRS's argument that there should be no small stock premium. In *Estate of Hendrickson v. Comr*. (T.C. Memo 1999-278), the IRS's appraiser ignored a small stock premium to his detriment. However, the Tax Court has twice denied a small stock premium (*Estate of Jung v. Comr*., 101 T.C. 412 (1993); *Barnes v. Comr*., (T.C. Memo 1998-413)). In *Estate of Thompson v. Comr*. (T.C. Memo 2004-174), the Tax Court rejected an additional premium to reflect risks of technology and the internet.

AVERAGE OF FACTORS

Sec. 7 of Rev. Rul. 59-60 warns appraisers not to merely take an average of factors. Nevertheless, some appraisers seem to have ignored that warning, and the courts have not failed to admonish them when they do. In *Martin Ice Cream Company v. Comr*. (110 T.C. 189 (1998)), the Tax Court criticized the taxpayer's appraiser for failing to explain how he used the weights between the three valuation approaches he employed. In *Estate of Ford v. Comr.* (T.C. Memo 1993-580), the court disregarded the estate's appraiser's weightings because he failed to explain why he selected the weightings. In *Estate of Smith v. Comr*. (T.C. Memo 1999-368), the Tax Court assigned weights of 70% to asset-based value and 30% to the income approach in determining the value of the subject company. In *Estate of Mueller v. Comr*. (T.C. Memo 1992-284), the Tax Court criticized the IRS's appraisers for seemingly picking the weights "out of the air." In *Estate of Dunn v. Comr*. (301 F. 3d 339 (5th Cir. 2002)), the Fifth Circuit assigned an 85% weight to an income approach and a 15% weight to an asset approach.

APPENDIX A
Revenue Ruling 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 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.

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.

SECTION 2. BACKGROUND AND DEFINITIONS

2.01. 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.

2.02. 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.

2.03. 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."

SECTION 3. APPROACH TO VALUATION

3.01. 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 difference 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 judgment, and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

3.02. 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.

3.03. 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.

SECTION 4. FACTORS TO CONSIDER

4.01. 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.

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

(a) The history of the 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 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) 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 profit taxes; (3) net income available for dividends; (4) rates and amount 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 non recurrent 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 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.

(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 the 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.

(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 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 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.

SECTION 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.

SECTION 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 corporation 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.

SECTION 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 results cannot be supported by a realistic application of the significant facts in the case except by mere chance.

SECTION 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, 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.

SECTION 9. EFFECT ON OTHER DOCUMENTS

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

APPENDIX B
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