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Alexander Grant & Company

Date January 2, 1980

OFFICE MEMORANDUM

To R. Nason; P. Bower From T.X.Sweeney; Tax Department

Client Megadiamond Industries

Subject Valuation of Closely-Held Corporation for Estate and Gift Tax Purposes

INTRODUCTION

Ascertaining the fair market value of shares of common stock in a closely-held corporation for purposes of Federal estate and gift taxation is a complex and elusive process. Over the years, the Internal Revenue Service, taxpayers and the courts have been frustrated in their attempts to satisfy the standard definition of fair market value contained in Regulation section 20.2031-1(b): "The price at which an asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and with both possessing a reasonable knowledge of the facts."

There are obvious inherent difficulties with this definition. To assume a willing buyer when there is none presents a common situation in estate and gift valuation cases. And rarely does either the buyer or seller have full knowledge of all relevant facts. However troublesome the above definition of fair market value may be, it does provide a good framework in which to pursue the determination of fair market value.

It must be remembered that numerous variations occur in valuation problems. Each company is unique. There is no set formula, nor can there be, for valuing a closely-held company. However, certain approaches to valuation and specific valuation guidelines or standards have been developed and/or accepted by the Service and the courts which have provided taxpayers reasonable methods for ascertaining realistic valuations for estate, gift and income tax purposes. The purpose of this memorandum is to identify and analyze the various approaches to valuation which are commonly utilized in valuing a closely-held corporation for estate and gift tax purposes.

DISCUSSION

One of the principal guidelines used in establishing corporate values is Revenue Ruling 59-60, 1959-1 CB 237. In this ruling the Service listed certain basic factors for use in the determination of closely-held stock for estate and gift tax purposes. The ruling does not provide objective answers to specific valuation questions; it does not set forth approved valuation formulas - and it is not supposed to. The purpose of the 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 and gift tax purposes." The ruling suggests that the following factors should be taken into account in determining the value of a closely-held business:

1) The nature of the business and the history of the enterprise from inception.

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

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

4) The earning capacity of the company.

5) The dividend-paying capacity of the company.

6) The existence of goodwill or other intangible assets.

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

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

While all of these factors, and others, are relevant to the determination of fair market value, the two most important factors (and the ones more often cited by the Service and the courts) are the company's earnings and the value of its net assets.

Net Asset Value

The starting point for determining net asset value of a business is its current balance sheet. Since such a statement reflects historical cost rather than current market value, only under rare circumstances will the book value represent the company's asset value. The balance sheet must be adjusted to reflect the differences between book figures and estimated or known market values. Also, the balance sheet may ignore contingent liabilities, unfavorable lease obligations, present or potential lawsuits, etc. After the balance sheet has been recast to reflect the fair market value of the assets, and adequate provision has been made for contingent liabilities, the resultant net asset value is more meaningful as a determinant of a company's value.

In the case of an operating company, the primary consideration in the valuation process, and one with which the Service typically agrees, is the earning capacity of the business. This is not to say that the net asset value will be an unimportant factor in the valuation of an operating company, but merely that it will not be the dominant consideration. In valuing a going concern business the "willing buyer" will normally place primary emphasis on the earning capability of the assets he is considering buying. The value of these assets will certainly enter into his decision but his paramount concern is - what profits can be generated from those assets.

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Earnings Capacity

In determining a company's earning capacity, it is first important to review its history of profits for a significant period, preferably five years. As with the balance sheet, it may be necessary to make certain adjustments to the income statements to reflect more realistic earnings. For example, if earnings have been depleted via excessive salaries, entertainment expenses or fringe benefits, profits for valuation purposes could be understated. On the other hand, income from non-operating assets, if significant, may cause profits to be overstated for valuation purposes. It is important that the income statements reflect realistic income and expense data as they relate to the assets employed by the business.

Both recent and average earnings should be considered. Average earnings are particularly appropriate if the company has demonstrated a history of fluctuating or cyclical profits. In some cases, weighted average earnings, giving more weight to recent years, may be more meaningful than an unweighted earnings figure. A careful analysis of the company's profit history and its future earnings projection is important for a proper determination of the company's normal earnings capacity.

Once the normal earnings figure has been calculated, an appropriate capitalization rate must be determined. This is clearly the most difficult and, at times, arbitrary aspect of determining a proper valuation for the closely-held business. The most prevalent capitalization method utilizes a multiple of normal after-tax operating earnings.

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The capitalization multiple must be consistent with a potential buyer's expectations of a reasonable return on his investment based on relative risks and to some extent, on current interest rates or dividend yields. The price-earnings multiple is actually the reciprocal of the rate of return expected by the potential buyer. As an illustration, assume a company generates net income of $100,000 and a buyer would, based on the nature of the business, the risks involved, etc. expect of return of 20% on the purchase of the company. The earnings multiple would be the reciprocal of 20%, or five, and when applied to the $100,000 net earnings figure would result in a value of $500,000 for the company.

The derivation of an appropriate capitalization rate or price-earnings multiple is, to a large extent, determined by the rate of return expected by a potential buyer. The higher the risk involved, the greater the buyer's expected rate of return and the lower the multiple which he will apply to the company's earnings. Therefore, in arriving at an appropriate multiple a number of relative risk factors must be examined. Several of the factors which must be considered are:

1) The nature of the business including its product mix and customer markets served. It is generally felt that the fewer the customers served, the higher the degree of risk.

2) The competitive efficiency of the company's production and distribution facilities.

3) Relationships with suppliers. Again, the fewer the suppliers, the greater the risk.

4) Analysis of the management group; it is generally believed that if the management group consists of a few highly qualified individuals possessing highly technical skills, the relative risk is greater. Industrial businesses, large and small, which depend on the special, often unusual skill of a select group of managers, warrant a high risk factor.

5) The stability of the company's earnings; enterprises which are vulnerable to shifting economic conditions are viewed as a more risky investment.

6) The financial condition of the business, including the working capital ratio, the availability and consistency of cash flow, the company's debt: equity ratio and the company's ability to borrow funds at reasonable interest rates.

A careful analysis of these factors, as well as additional factors where necessary, can provide a workable framework for assessing the relative risks associated with the business being valued. A realistic capitalization rate can then be developed which is consistent with the results of this analysis, as well as the general market conditions present at the time of valuation.

A popular and accepted factor to consider in developing the price-earnings multiple to be applied to a company's earnings is to use the comparable company method. This technique takes into consideration, in addition to all other factors, the value of stock of corporations engaged in

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the same or similar lines of business which have a public market for their stock. This method is preferable to selecting a price-earnings multiple based only on an assessment of risk and judgement as described above, but it is certainly not without its drawbacks. Since it is impossible to find an exact comparative, the statistics of comparable companies must be used more as a guide than a definite formula. In selecting the companines which are comparable, a meticulous gathering of factual data on the industry and its components is essential. Generally, smaller companies which are traded on the over-the-counter markets provide the best comparisons.

Once a price-earnings multiple has been determined and applied to normal earnings, the resulting value should be related to the net asset value as was discussed above. The company's value as derived by its earnings capacity might have to be adjusted under circumstances where the relationship between earnings value and net asset value is significantly different. For example, assume the capitalized value of a company's earnings is $1,000,000 and its net asset value is $2,000,000. It is unlikely that the value of the business would be worth $2,000,000, as the earnings on these assets fall considerably below any reasonable expected return on them. The business is probably worth somewhere between $1,000,000 and $2,000,000. Its value will be determined by giving a certain weight factor to earnings value, another weight factor to asset value and in cases involving estate and gift tax valuations, the value based on earnings paid out (i.e., dividend paying capacity) is often given weighted consideration.

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The case of Central Trust Co., Co-Executor, 305 F.2d 393 (Ct. Cls., 1955), is a particularly good example of the judicial approach to the weighting of pertinent factors in the valuation of a closely-held business. The case involved the valuation for estate tax purposes of 30,000 shares of common stock. After exhaustive investigation by both the Government and the executor's expert witnesses, the court held that earnings were the most important factor, and gave the earnings factor a 50% weight. Further, the court said dividends, which are primarily a function of earnings, should be given a 30% weight, and to book value it gave a weight of 20%. The court then applied these weight factors to the company's respective earnings value, dividend yield value, and book value to arrive at a gross value of the company. Finally, a discount of approximately 12% was allowed to reflect the lack of marketability of the closely-held stock. In Bader's Estate 59-1 USTC 9431 the court assigned earning power a weight of two while dividend yield and book value were assigned a weight of one. The combined total was divided by four, and the resulting weighted average value was discounted by 10% to reflect the lack of marketability of the decedent's interest. In arriving at the book value used in the formula, the court allowed an additional discount of 40% of the book value because comparable, listed companies in the same industry were selling at 60% of their book value. In effect, the court allowed an internal discount of 40% of book value, before arriving at the weighted average value, and then allowed an external discount of 10% on the entire weighted average value.

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It is a well established principle that the fair market value of a closely-held business is generally less than the value computed by the earnings capitalization and net asset valuation methods. The gross value of a business derived from these techniques is subject to adjustment in a final determination of value by various factors. The principal limiting factor is marketability, although other elements may suggest further discounting. One of the more significant potential limiting factors is the size and nature of the block of stock to be valued. Generally, a minority interest in a company is deserving of a larger discount than one which represents a control position. Other limiting factors include the potential loss of a key member of the management team and the size and position of the company in its industry, especially if comparison has been made with much larger or dominant companies in deriving the capitalization factor. The general range of discounts acceptable to the IRS is from 10% to 25%, although the utilization of a discount factor is primarily a subjective determination and will vary from case to case. However, a minority interest in a small closely-held corporation which has little or no dividend-paying capability should warrant a substantially higher discount, possibly 40% or more.

<u>CONCLUSION</u>

While the IRS, for estate and gift tax valuation purposes, relies primarily on price-earnings ratios of comparable listed companies, it also recognizes the value of utilizing a weighted average formula approach where comparable

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listed companies do not exist. Primary emphasis is placed on the earning capacity or the potential earning capacity of the company. The most difficult task is determining an appropriate and realistic capitalization rate. Current interest rates and stock market capitalization ratios provide a good overall framework with which to initiate a capitalization study. However, the earnings capitalization multiple for any particular closely-held company must ultimately be determined by analyzing the inherent risks of the business.

TXSweeney/an