Highlights of IRS Revenue Ruling 59-60

This revenue ruling outlines the general approach, methods, and factors which must be considered in valuing securities for estate and gift tax purposes.

Fair Market Value is defined 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."

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 fair market value of specific shares of stock will vary as general economic conditions change.

The value of shares of stock of a company with very uncertain future prospects is highly speculative.

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.

Fundamental Factors to be considered in determining Fair Market Value

(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
(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 of the company
(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 sticks actively traded in a free and open market, either on an exchange of over-the-counter

Nature of the Business and History of the Enterprise

The history shows past stability or instability, growth, diversity of operations and other facts needed to form an opinion of the degree of risk involved in the business.

Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

The Economic Outlook in General and the Condition and Outlook of the Specific Industry

Current and prospective economic conditions, both in the national economy and in the industry or industries with which the corporation is allied, must be considered as of the date of appraisal.

The loss of the manager may have a depressing effect upon the value of the stock, particularly if there is a lack of trained personnel capable of succeeding. 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.

The Book Value of the Stock and the Financial Condition of the Business

Consideration should be given to any assets not essential to the operation of the business.

In computing book value per share, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly.

The Earning Capacity of the Company

The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered.

Arbitrary five or ten year averages without regard to current trends or future prospects will not produce a realistic valuation. If trends are obvious, greater weight may be accorded the most recent years' profits in estimating earning power.

Dividend Paying Capacity

Recognition must be given to the necessity of retaining a reasonable portion of profits to meet competition.

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.

Whether or not the Enterprise has Goodwill or Other Intangible Value

Goodwill is based on earning capacity. Presence and value of goodwill rest on the excess of net earnings over and above <u>a fair return on the net tangible assets</u>

Whatever intangible value there is may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

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

Sales of stock should be carefully investigated to determine whether they represent arms' length transactions. 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.

Market Price of Corporations Engaged in Same or Similar Business Actively Traded

The only restrictive requirement specified in the statute is that their lines of business be the same or similar, it is obvious that consideration must be given to other relevant factors. 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. A company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

WEIGHT TO BE ACCORDED VARIOUS FACTORS

Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others.

Value of a closely held investment or real estate holding company is closely related to the value of the assets underlying the stock

Adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

CAPITALIZATION RATES

A determination of the proper capitalization rate presents one of the most difficult problems in valuation.

No useful purpose is served by taking an average of several factors (for example book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

RESTRICTIVE AGREEMENTS

Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes.

Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value.

Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide 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. See Rev. Rul. 157 C.B. 1953-2,255 and Rev. Rul. 189 C.B. 1953-2,294.