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The valuation of closely held stocks for federal estate taxes

Carroll Lee Saine

THE VALUATION OF CLOSELY HELD STOCKS FOR FEDERAL ESTATE TAXES

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CARROLL LEE SAINE

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INTRODUCTION

Valuing closely held stocks for federal estate tax purposes has always been one of the most troublesome and challenging problems in the field of estate administration. The Internal Revenue Code and Regulations provide that all relevant factors in each case should be considered in arriving at a fair market value,[1] and therefore, any formula approach to the problem is generally a rule-of-thumb estimate. The courts have pointed out in many cases that fair market value is not a matter of rules but of individual judgment to be applied in each case.[2]

The importance of such valuation with respect to aggregate estate tax liability is obvious since the tax is computed on the basis of the total value of all assets in the estate. Generally, this type of value is almost always a disputed item since such valuation is not an exact science.[3] This puts the executor on the defensive in many cases to justify the amount of taxes paid on a figure that is necessarily an informed estimate.

Purpose

The purpose of the thesis, stated simply, is to give some insight into the problem of intelligent valuation and attempt to show that no rigid formulas can be developed to solve the unsatisfactory situation that now exists in taxing closely held stocks.

Since this thesis will be confined to valuation for estate taxes, intelligent investment analysis of common stocks cannot be considered independently of the valuation guidelines set forth by the Internal Revenue Code and court decisions. Accordingly, the approach to the problem will consist of a combination of security analysis for valuing closely held stocks combined with evidence from the courts, and methods of Treasury Department Agents. A number of the major relevant factors and the more important valuation methods used in supporting valuation figures will be discussed. Evidence will be given to support the view, however, that the various methods of valuation and other considerations, at this juncture, will not guarantee that a given valuation will be accepted by the tax authorities. The decisions of the courts, moreover, appear to be too unpredictable to give any real consistent guidance.

All too often fiduciaries (an individual or a trust institution charged with the duty of acting for the benefit of another party) merely stand by and pay taxes on whatever value the Revenue agent places on stock simply because of the uncertainty of valuation methods. In addition, in many cases, some fiduciaries are unable to justify valuations because the Internal Revenue Service's values are presumed correct until proven wrong in the courts. It is anticipated that this analysis will prove to be of some value in helping fiduciaries pay no more than their fair share of estate tax when closely held stocks are involved by giving evidence of formula valuations and other relevant data that will add to the fiduciary's argument in substantiating its figures.

FOOTNOTES

CHAPTER I

1. Treasury Department Regulation 20.2031 (b); Revenue Ruling 59-60, IRB 1959-1, CB 237

2. Hamm v. Commissioner, 8th Circuit Court of Appeals, 17,121, 17,122; Estate of Frank L. Gray v. Commissioner, P-H T.C.M. para. 51,257; Morris Miller v. Commissioner, P-H T.C.M. para. 53,155

3. John F. Manly, "Valuation of Common Stock of Unlisted Corporation," Taxes, August, 1955, p. 584

4. Estate of Frank L. Gray, op. cit; Estate of Morris Braverman v. Commissioner, P-H T.C.M. para. 62,021

Chapter II

THE PROBLEM OF VALUATION

Importance of Fair Market Value

In the complex field of federal estate taxation, one of the most important areas of responsibility for the executor is valuation. The law requires that property included in the taxable estate be valued at fair market value. The relationship of tax liability to valuation is obvious.[1] As pointed out in Table I, page 6, the level of tax payable under provision of Section 2001 of the Internal Revenue Code of 1954 ranges from 3 per cent up to 77 per cent of the net taxable estate. Accordingly, in many estates only a slight over-valuation can result in a sizable increase in the estate's tax liability when a large block of closely-held stock is involved.[2]

Market value is in effect the price at which property will change hands between a willing buyer and a willing seller when neither is under any compulsion to buy or sell.[3] However, in the case of close corporation stock there usually is no established market to determine a representative value. One leading authority in the field has stated:

> "Valuation of stock of a closely held company is an attempt to determine the fair market value of an asset which by definition does not have a fair market

Table I

Federal Estate Tax Rates

Taxable Estate (After deducting the $60,000 exemption) From	To	Tax =	+ %	Of Excess Over
0	$ 5,000	0	3	0
$ 5,000	10,000	$ 150	7	$ 5,000
10,000	20,000	500	11	10,000
20,000	30,000	1,600	14	20,000
30,000	40,000	3,000	18	30,000
40,000	50,000	4,800	22	40,000
50,000	60,000	7,000	25	50,000
60,000	100,000	9,500	28	60,000
100,000	250,000	20,700	30	100,000
250,000	500,000	65,700	32	250,000
500,000	750,000	145,700	35	500,000
750,000	1,000,000	233,200	37	750,000
1,000,000	1,250,000	325,700	39	1,000,000
1,250,000	1,500,000	423,200	42	1,250,000
1,500,000	2,000,000	528,200	45	1,500,000
2,000,000	2,500,000	753,200	49	2,000,000
2,500,000	3,000,000	998,200	53	2,500,000
3,000,000	3,500,000	1,263,200	56	3,000,000
3,500,000	4,000,000	1,543,200	59	3,500,000
4,000,000	5,000,000	1,838,200	63	4,000,000
5,000,000	6,000,000	2,468,200	67	5,000,000
6,000,000	7,000,000	3,138,200	70	6,000,000
7,000,000	8,000,000	3,838,200	73	7,000,000
8,000,000	10,000,000	4,568,200	76	8,000,000
10,000,000		6,088,200	77	10,000,000

State Death Tax Credit

Taxable Estate (After deducting the $60,000 exemption) From	To	Tax =	+ %	Of Excess Over
0	$ 40,000	0	0	0
$ 40,000	90,000	0	.8	$ 40,000
90,000	140,000	$ 400	1.6	90,000
140,000	240,000	1,200	2.4	140,000
240,000	440,000	3,600	3.2	240,000
440,000	640,000	10,000	4	440,000
640,000	840,000	18,000	4.8	640,000
840,000	1,040,000	27,600	5.6	840,000
1,040,000	1,540,000	38,800	6.4	1,040,000
1,540,000	2,040,000	70,800	7.2	1,540,000
2,040,000	2,540,000	106,800	8	2,040,000
2,540,000	3,040,000	146,800	8.8	2,540,000
3,040,000	3,540,000	190,800	9.6	3,040,000
3,540,000	4,040,000	238,000	10.4	3,540,000
4,040,000	5,040,000	290,800	11.2	4,040,000
5,040,000	6,040,000	402,800	12	5,040,000
6,040,000	7,040,000	522,800	12.8	6,040,000
7,040,000	8,040,000	650,800	13.6	7,040,000
8,040,000	9,040,000	786,800	14.4	8,040,000
9,040,000	10,040,000	930,800	15.2	9,040,000
10,040,000		1,082,800	16	10,040,000

Source: Internal Revenue Code of 1954, Sec. 2001 value, since a market wherein a willing buyer will meet a willing seller, neither under a compulsion, generally does not exist."[4]

The complexity of the problem, and perhaps one of the best concepts of value, is further borne out in the leading case of James Couzens concerning the value of Ford Motor Company stock as of March 1, 1913. In this case, the Board of Tax Appeals said:

"It has been said that value is the price at which a willing seller and a willing buyer would agree to trade if both were aware of the facts. As to a complete transaction, this is a simple statement. But there is a great difference between finding value from an actual transaction and finding it by assuming from the circumstances a hypothetical transaction from which value is to be inferred. Here the problem is to determine as of a past date the fair market values or value of property the like of which was not involved at the time in any transaction, and as to which there was no willing seller or willing buyer and no direct evidence of the considerations which would actively have moved them to buy or sell such property. We have sought to place ourselves on March 1, 1913, - recognizing all the facts in existence, and from them attempting reasonably to predict those to come, being neither unduly skeptical nor unduly optimistic, we have sought to determine what an intelligent and reasonable seller and/or intelligent buyer would in their fairly mercenary interests have been most likely willing to agree upon as a price for the property in question. Clearly opinions might differ as to such a price...a common figure must be agreed upon."[5]

It is the interpretation of fair market value that presents the dilemma in determining asset valuation of the closely held corporation.[6] In the case of General Motors stock, it is the price that can be realized by sale on the New York Stock Exchange. Here the law of supply and demand can be seen in operation. Some investors may decide the current prices are satisfactory and buy; others may decide they are too high and sell. The Internal Revenue Service has recognized that this type of active market represents the best determinant of value.[7] In the absence of actual market prices, a meaning of value that is acceptable both to the taxpayer and to the tax authorities must be arrived at.

Because of the uncertainty of valuation methods and the duty to conserve the estate, there is a natural tendency to be conservative in arriving at a value by the executor.[8] On the other hand, to the Revenue agent who has a duty conscientiously to attempt to obtain a tax on the true value, the approach to value may have a different meaning. The foregoing is excellently pointed out in the case of Lingo v. Commissioner when the taxpayer contended a value of $800.00 per share for the stock of F. J. Stoke Machinery Company, and the tax authorities contended a value of $1,750.00. The court found a value of $1,125.00 per share, stating, "No useful purpose would be served by attempting to state the general principles we have applied in arriving at our determination of value. Under the facts and circumstances here presented, valuation is necessarily an approximation derived from the evaluation of elements not readily measured."[9]

Despite the realm of uncertainty in arriving at value, only the inexperienced will attempt to submit a value well below a realistic figure. Such an approach will seldom pass the critical examination of taxing authorities, and ultimately the estate will not only be liable for additional taxes but also interest on the deficiency at 6 per cent. [10] In addition, experienced fiduciaries should realize that a valuation will be more readily accepted if the examining agent feels that a conscientious, as well as intelligent, attempt has been made to arrive at fair market value. [11] While the official policy of the Internal Revenue Service is for the examining agent to make a critical analysis of closely held stock, considering "all relevant factors", it is a well known fact that due to the pressure of time and ever-growing backlog of audit cases, many agents arrive at their own estimate of value by hurried rule of thumb estimates. Accordingly, in any audit conference, the fiduciary that is armed with facts and whose judgment the agent learns to respect is more likely to prevail. On the other hand, however, an unrealistically low valuation is only an open invitation for the agent to determine a value that is unrealistically high. Then a compromise figure may only be reached by settlement in the Tax Court. [12]

The Valuation Process...A Challenge to the Fiduciary

A ruling of the Internal Revenue Service has defined a "close corporation" as a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling. [13] In 1961 in the United States there was a total of 1,140,575 active corporations, the majority of which may be considered as close corporations. [14] In the metropolitan area of Richmond, Virginia alone, an area of over 400,000 population, there are approximately 5,000 manufacturing, wholesale and retail establishments, [15] many of which will ultimately pass through the hands of an executor. These statistics highlight the fact that the opportunities in the field of legal valuation are great, and the future of many small businesses will, at least in part, be affected by the actions of fiduciaries.

Experts in the field of valuation point out that many factors must be taken into consideration in determining the value of closely held securities. The Internal Revenue Service, in its Revenue Ruling 59-60, recognizes that no set formula can be devised that will be generally applicable to all valuation cases and points out that a sound valuation must be based upon all relevant factors. [16] Since the question of fair market value is one of fact rather than law, it is obvious that we cannot legislate legal principles that can govern the solution of a specific valuation problem. Factors that weigh heavily in some cases may warrant little or no consideration in others. Thus it is impossible to develop a general set of rules or principles to follow in solving a particular problem. Accordingly, we find that most writers on the subject of security analysis pass over close corporations as not coming within the purview of practical analysis.[17]

> "Analysis connotes the careful study of available facts with the attempt to draw conclusions therefrom, based on established principles and sound logic. It is part of the scientific method. But in applying analysis to the field of securities, we encounter the serious obstacle that investment is, by nature, not an exact science."[18]

In the valuation process for closely held securities, one must estimate what someone will pay for a stock that has no market price and is not being offered for sale. This makes the problem even more complex and each problem is unique. As Dewing said:

> "Value is subjective; it is based on individual experience. Hence, when the individual tries to find an objective standard or criterion for his own personal values, he is confronted with endless confusion...In the end, the test of value is pragmatic -- where does the judgment of most men meet? It is the composite of many judgments, not the reaching for an illusory fixed and invarying basis of value on which the judgment of all men should agree."[19]

It has been said that a general indication of a reasonable fair market value of closely held stock will be a value which the buyer thinks is too high and the seller thinks is too low.[20] When a fiduciary submits a valuation of a closely held stock, he must support this value with convincing evidence. He must be prepared to show that proper consideration has been given to all the qualitative and quantitative aspects of analysis and that each aspect has been weighed properly in arriving at a price. The necessity of such evidence is evident since the tax authorities' valuation is considered *prima facie* correct unless the fiduciary can overcome his presumption by effective presentation of convincing evidence.[21] Thus, it is readily apparent that excess valuation can occur if the taxpayer does not intelligently approach the valuation process.

In placing the burden of proof on the taxpayer in valuation cases, Professor Ralph C. Rice concludes that the Internal Revenue Service has an unfair advantage over the taxpayer and in many cases its valuation will prevail even if its investigation has been lacking in depth.[22] The court's position on the burden of proof was stated clearly in the Estate of Frank L. Gray when the Commissioner's valuation of the stock of Gray-Heldredth Company at $277.43 per share prevailed. Here the court determined that the Commissioner was correct when the taxpayer, in the opinion of the court, failed to prove the valuation erroneous.[23] Similarly, in Penn-Warrington Hosiery Mills v. Commissioner, an income tax case, the Court decided in favor of the Commissioner, stating:

> "Petitioner has the burden of proving the valuation used by the respondent was erroneous. Fair market value is a question of fact to be determined from all the evidence. Apart from some broad generalizations, for the most part unsupported, (the) petitioner introduced no evidence to show that the fair market value of 50 shares of its stock was less than $55,998.66."[24]

On the other side, however, the courts have decided in favor of the taxpayer when convincing evidence is produced that weakens or shows error in the valuation of the Commissioner.[25]

Dr. Alfred R. Oxenfeldt, in a study of the various factors to be considered in arriving at value, concluded that valuation must combine expert opinion as well as effective interpretation of statistical data.[26] Evidence from the courts continues to reflect Dr. Oxenfeldt's thinking, as in the recent case of Hamm v. Commissioner, decided recently by the 8th Circuit Court of Appeals. The court, in affirming the Tax Court's decision in favor of the Commissioner, said:

> "The valuation of closely held stock is basically a question of judgment rather than of mathematics. We feel that the taxpayer's argument here comes down to a demand for a formula. Formulas, however, are only tools. With the kind of evidence presented here, we need not, and do not, go so far as to require that a detailed computation leading to the determined value be present in the Tax Court's findings."[27]

While each valuation case is a special situation that cannot be solved by any mechanical formulas, the fiduciary must possess a knowledge of soundly conceived valuation techniques in order to obtain a fair, realistic valuation.[28] The importance of this knowledge is borne out by a survey conducted by the Harvard Graduate School of Business Administration. The general conclusion of the informed observers surveyed was that Treasury agents ordinarily will agree to a reasonable valuation provided the taxpayer's case is carefully and effectively presented.[29]

Internal Revenue Code Provisions and Regulations

In the United States, the first federal estate tax was imposed in

1916 and subsequently has been amended and revised many times. The estate tax law was re-written in Subchapter A of Chapter 11 of the Internal Revenue Code of 1954. Several minor changes were made in 1956, and further changes were added under the Technical Amendments Act of 1958. In its present form, the Code provides that the gross estate of a decedent shall be determined by including the value, at the time of his death, of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States.[30] In addition, the Code provides the executor or administrator with the election to value the property in the decedent's gross estate one year after death.[31] The latter provision is intended to provide the estate with an opportunity to take advantage of declining values following the death of the decedent.

The statues, with the important exception of non-traded securities, provide no method for the valuation of property in the gross estate.[32] The Regulations, however, provide that the value of every item of property includable in a decedent's gross estate is its fair market value at the time of the decedent's death, or at the alternate valuation date, if elected. Fair market value is defined in the Regulations as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts, and is not to be determined by a forced sales price. All relevant facts and elements of value are to be considered in every case.[33]

To determine the value of unlisted securities, the Code states:

> "In the case of stock and securities of a corporation, the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange."[34]

It is interesting to note that Congress failed in the first federal estate tax adopted in 1916 through the present Internal Revenue Code of 1954 to define the meaning of "value". The true meaning has been left to Treasury Regulations, Revenue Rulings, and court decisions. The interpretation of the statutory term "value" by Regulation 20.2031-1(b), Revenue Ruling 59-60, and court decisions,[35] supports the conclusion that value and fair market value are one and the same. While the argument may be presented that for the untraded stock with no market the terms "value" and "fair market value" have different meanings, such a conclusion would only add to the complexity of resolving a valuation problem.

The term "close corporation" does not appear in the statutes nor regulations, but is defined in Revenue Ruling 59-60 in the words of a decision,[36] as meaning those corporations which are owned by a relatively limited number of stockholders with the result that little, if any, trading in the shares takes place. There is, therefore, no established market, and any sales that occur at irregular intervals seldom reflect the elements of a representative transaction as defined by the term "fair market value".[37]

This same ruling, which supersedes Revenue Ruling 54-77,[38] sets forth the fundamental factors, although not all-inclusive, that require careful analysis in each case:

(a) The nature of the business and the history of the enterprise.
(b) The economic outlook in general and the condition of the specific industry.
(c) The financial condition of the business and the book value of the stock.
(d) The earning capacity of the company.
(e) The dividend-paying capacity of the company.
(f) Whether or not the business has good will 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 exchange or over-the-counter.[39]

Thus, a number of rules to follow have been given, but no basic formula.[40] In some cases, net worth may be given the greatest weight, in others, earnings may be the prime factor, business conditions in yet another, and at other times, the capacity of management may be the most important. One factor may be weighed heavily in one case and considered only as a minor factor in another.[41] The Ruling specifically points out that while a sound valuation will be based upon all relevant facts, the elements of common sense, informed judgment, and reasonableness must enter into the process of weighing these facts and determining their aggregate significance.[42]

The 1959 Ruling, in emphasizing the necessity to look at the market value of stocks of companies similar in nature, took a long stride in helping to minimize wide differences of opinion in the area of valuation.[43] This emphasis was omitted from the 1954 Ruling, and thus agents, in many cases, apparently overlooked one of the most important tools in valuation work.[44] While it had been a general practice of fiduciaries to give weight to market prices of companies engaged in a similar line of business, agents had been reluctant to go along in the absence of official support.

The 1959 Ruling also broadened comparison with similar stocks which is confined in Section 2031(b) to stocks listed on an exchange. The new ruling also endorsed the use of actively traded over-the-counter stocks in selecting comparative analysis. Since there are only approximately 3,000 stocks listed on the various stock exchanges throughout the country, in comparison to approximately 25,000[45] traded on the over-the-counter market, this new section of the Ruling helped to relieve, somewhat, the difficult problem of finding comparative companies.[46]

Revenue Ruling 59-60 represented important progress in placing valuation on a more scientific approach, but the difficulty that will always remain, however, is finding a truly comparative stock since no other company is exactly the same as the one being valued.[47]

The Pattern of Court Decisions

When the taxpayer and the examining agent fail to agree on a valuation, the normal procedure is for the taxpayer to request an informal conference at the office of the District Director. If agreement cannot be reached at this level, the next step is a conference with the Appellate Division of the Regional Commissioner. If agreement still is not reached, the next step is litigation in the Tax Court. From the Tax Court, a decision may be appealed to the Federal Courts. More often than not, however, a compromise figure is agreed upon by the taxpayer and the authorities before a case reaches the court level.

While it is apparent that the taxpayer has numerous opportunities to appeal his case, many leading observers in the field conclude that the taxpayer is always at an unfair disadvantage since the burden of proof is on the taxpayer and the presumption of a correct value on the part of the Commissioner is difficult to overcome.[48] Douglas Van Dyke, in a critical indictment of valuation proceedings, concluded that it is impossible for the estate to obtain a fair valuation unless the court is shocked by an arbitrary or excessive valuation.[49] Many cases also support the conclusion that the taxpayer's position is hampered by the reliance of the Tax Court on the Commissioner's determination of value.[50]

There have been many complaints among practitioners regarding the uncertainty of the courts. The lack of any uniform standards results also in greater weight being given to the valuation of the Commissioner.[51]

R. L. Rockefeller concludes that while some values as determined by the courts are below what may be considered fair market value, the majority are considerably above.[52] W. T. Hackett, in his experience as a Trust Officer in analyzing over 400 family-held corporations, concludes that there is a deliberate attempt on the part of the government to claim the highest possible value which is too often upheld by the courts. He observes that in a compilation of 62 cases involving disputes as to value, only 6, or 10 per cent, were settled on the basis of the taxpayer's claim, and only 19, or 30 per cent, were settled at a lower than the mean of the taxpayer's and the Commissioner's claimed values. In 66 per cent of the cases, the government's claim as to value was sustained, and in 4 per cent of the cases, a value somewhere between the mean and the Commissioner's value was upheld.[53]

It is common knowledge that value in many cases became a "horse-trading" affair, and the courts have been criticized as having a tendency merely to act as arbitrators and settle on a mean value.[54] In a study of 25 valuation cases taken from Prentice-Hall, Inc. Tax Court Service Reported and Memorandum Decisions over the past ten years, as shown in Table 2 on page 20, one can see that while the decisions of the Court reveal no definite pattern, there is a tendency on the part of the Court to take a middle ground in most cases.

In the opinion of Homer I. Harris, the only useful purpose that

Table II

Selected Tax Court Valuation Decisions, 1954-63

Year of Decision	P-H Tax Court Para.	Comm. v.	Value Per Share		
			Taxpayer	Comm.	Tax Court
1954	54,023	Estate of Albert Wolfe	$ 120.00	$ 307.78	$ 160.00
1954	54,145	Pamela N. W. Lingo	800.00	1,750.00	1,125.00
1954	54,271	Estate Of Harry Hammond	236.45	900.00	550.00
1955	55,041	Estate of Hazel K. Bakewell	864.00	1,500.00	1,100.00
1955	25.7	Estate of D. B. Givens	40.00	195.00	60.00
1955	55,129	Estate of Eugene H. Kelly	516.13	4,000.00	2,200.00
1956	56,003	Estate of B. S. Prentice	147.00	250.00	147.00
1956	56,272	Drilling and Service, Inc.	4.00	5.00	4.00
1957	27.76	Estate of T. W. Tebb	100.77	146.00	146.00
1958	58,038	Estate of E. F. Luckenbach	114.75	229.52	175.00
1958	58,157	Florence M. Harrison	400.00	585.00	585.00
1958	31.21	Estate of O. B. Littick	200,000.00	257,911.00	200,000.00
1959	59,038	Kathleen L. Gibbs, et al	1,000.00	2,500.00	1,100.00
1959	59,120	Estate of D. S. Levenson	250.00	1,033.00	900.00
1959	59,183	Estate of B. F. Thomson	225.00	535.00	283.50
1960	60,054	Paulina Dean, et al	425.00	884.17	640.00
1961	61,100	Bruce Berckmans, et al	1.00	9.00	1.00
1961	61,225	Celia Waterman	126.50	423.00	250.00
1962	62,085	Zerwick Jewelry Co.	110.00	507.00	507.00
1962	62,284	North American Phelps Co., Inc.	no value	23.75	8.08
1962	62,021	Estate of Morris Braverman	786.80	1,150.00	1,066.88
1963	63,033	N. S. McCarthy, et al	0	1.30	1.30
1963	63,059	A. L. Kimmes	.01	.04	.02
1963	63,186	Estate of M. G. Brush	3.00	7.37	5.50
1963	40.15	Estate of H. S. Leyman	195.00	850.00	630.00

Source: Prentice-Hall, Inc., Tax Court Reported and Memorandum Decisions valuation cases can serve is to give insight into the factors which have been considered.[55] Merten states that the Tax Court seems to refuse to pinpoint the basis of its valuation. In the statement of the facts, much data is presented, and in their opinions, the Courts state they have considered all "relevant factors", and have heard the expert testimony and arrived at a certain value.[56]

This lack of guidance is further borne out in Hamm v. Commissioner when the court, in quoting from the opinion rendered in Penn v. Commissioner, 219F.2d 18,20-21, said: "There was no need to state the process by which valuation was attained except to make clear that all appropriate factors required by law to be taken into consideration were, in fact, weighed."[57]

FOOTNOTES

CHAPTER II

1. Treasury Department Regulation 20.2031-1(b)

2. For a further discussion, see J. D. Muir, "The Estate and Gift Valuation of Closely Held Company Stock", Virginia Law Review, March, 1964, pp. 337-352

3. Treasury Department Regulation 20.2031-1(b)

4. J. E. Tierney, Jr., "A New Approach to the Valuation of Common Stock of Closely Held Companies", Journal of Taxation, July, 1962, p. 14

5. James Couzens, 11 B.T.A., 1040

6. Southwestern Bell Telephone Co. v. Public Service Commission, 262 U.S. 276, 310

7. Treasury Department Regulation 20.2031-2

8. W. T. Hackett,"Discriminatory Effect on Estate Taxes", Taxation and Business Concentration, Princeton Tax Institute, 1952, p. 197

9. Pamela N. W. Lingo v. Commissioner, P-H T.C.M., para. 54,145

10. Estate Plans, Institute for Business Planning, Inc., New York, p. 15,403

11. Interview with Thomas Mason, Estate Tax Examiner, Internal Revenue Service, Richmond, Virginia

12. Estate Plans, op. cit., p. 15,402

13. Revenue Ruling 59-60, IRB 1959-1, CB 237

14. The Economic Almanac 1964, National Industrial Conference Board, Inc., New York, 1964, p. 151

15. Richmond Chamber of Commerce

16. Revenue Ruling 59-60, op. cit.

17. Graham & Dodd, Security Analysis, McGraw - Hill Book Co., Inc., New York, 3rd ed., 1951, p. 2

18. Graham & Dodd, op. cit., p. 24

19. Arthur S. Dewing, The Financial Policy of Corporations, Ronald Press Co., New York, Vol. 1, 1953, p. 277

20. O'Neal and Derwin, Expulsion or Oppression of Business Associates, Duke University Press, Durham, 1961, p.35

21. Treasury Department Regulations 20.2031-1(b) and 25.2512-1

22. Ralph C. Rice, "The Valuation of Close Held Stocks: A Lottery in Federal Taxation", University of Pennsylvania Law Review, December, 1950, p. 385

23. Estate of Frank L. Gray v. Commissioner, P-H T.C.M. para. 51,257

24. Penn-Warrington Hosiery Mills, Inc. v. Commissioner, P-H T.C.M., para. 61,211

25. Samuel S. Schabet, et al v. Commissioner, P-H T.C.M. para. 59,051

26. Dr. Alfred R. Oxenfeldt, "Valuation of Untraded and Closely Held Securities", The Analyst Journal, August, 1953, p. 65

27. Hamm v. Commissioner, 8th Circuit Court of Appeals, 17,121,17,122

28. For a check-list of items to consider in legal valuations, see Appendix A. Also see Joseph E. Tierney, Jr., op. cit., p. 14, for a comprehensive discussion of quantitative and qualitative factors to consider in approaching a legal valuation problem.

29. J. K. Butters, "Recent Trends in Industrial Concentration and Taxation", Taxation and Business Concentration, Princeton Tax Institute, 1952, p. 15

30. Internal Revenue Code of 1954, Section 2031(a)

31. Internal Revenue Code of 1954, Section 2032(a)(2)

32. Internal Revenue Code of 1954, Section 2031(a)

33. Treasury Department Regulation 20.2031-1 (b)

34. Internal Revenue Code of 1954, Section 2031(b)

35. Gamble v. Commissioner, 101F 2d, 565; James Couzens, 11 B.T.A., 1040

36. Brooks v. Willcuts, 78 F 2d, 270

37. Revenue Ruling 59-60, op. cit.

38. Revenue Ruling 54-77, IRB 1954-1, CB 187

39. Revenue Ruling 59-60, op. cit. This Ruling is currently the basic guideline for Revenue agents in arriving at fair market value and every student of the problem should be thoroughly familiar with its basic content.

40. Homer I. Harris, Handling Federal Estate and Gift Taxes, Baker, Vooris & Co., Inc. Mount Kesco, New York, 1959, p. 73

41. See Harris for numerous cases concerning weight given to various factors, p. 74

42. Revenue Ruling 59-60, op. cit.

43. Ibid

44. For a comparison of the two Rulings see John B. Weed, "Valuation Rules Changed," Trusts and Estates, April, 1959, pp. 312-14

45. Graham & Dodd, op. cit., p. 2

46. John B. Weed, op. cit., p. 312

47. Ibid

48. Jacob Mertens, The Law of Federal Gift and Estate Taxation, Lofet Publications, Inc., Sangertus, New York, 1959, Vol. 1, p. 539; Dr. Alfred R. Oxenfeldt, op. cit., p. 65; Douglas Van Dyke, "Commissioner Unfair to Fair Market Value," Taxes, September, 1945, p. 789; R. L. Rockefeller, "Valuation of Closely Held Stocks for Estate and Gift Tax Purposes," Taxes, April, 1958, pp. 259-60; Ralph C. Rice, op. cit., p. 385

49. Douglas Van Dyke, op. cit., p. 789

50. Heininger v. Commissioner, 320 U.S. 476; Avery v. Commissioner, 22F (2d) 6; Estate of Frank L. Gray v. Commissioner, op. cit., Penn-Warrington Hosiery Mills, Inc. v. Commissioner, op. cit.

51. Douglas Van Dyke, op. cit., p. 789; W. T. Hackett, "Discriminatory Effect on Estate Taxes" and Edward N. Polisher, "Effect of Estate, Inheritance and Gift Taxes on Business Development and Survival," Taxation and Business Concentration, op. cit., pp. 197-207, 175-197

52. R. S. Rockefeller, op. cit. p. 260

53. W. T. Hackett, op. cit., p. 198

54. C.C. Bosland, "Tax Valuation by Compromise," Tax Law Review, November, 1963, p. 159

55. Homer I. Harris, Handling Federal Estate and Gift Taxes, Baker, Vooris & Co., Inc.,Mount Kesco, New York, 1959, p. 74

56. Jacob Mertens, op. cit., p. 591

57. Hamm v. Commissioner, op. cit.

Chapter III

VALUATION FACTORS

Nature of the Business

Nature of the business is an important means of determining value and warrants consideration in each case. Concerning the nature and history of a business entity, Revenue Ruling 59-60 reads as follows:

> "The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business...The history to be studied should include, but 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." [1]

The first factor to be considered in the valuation of any security should most logically be a study of the past history of the business and the nature of the industry it represents.[2] The past record of a business reflecting successful growth may warrant a higher valuation whereas a less successful past will often justify a lower figure. Any valuation, therefore, must take into account the historical aspects of the operating concern and its past economic health. Second, consideration should be given to the cyclical aspects of its future production and sales. It is also important to determine if the industry is subject to displacement or to overwhelming new competition.[3]

It is evident that the degree of business risks varies greatly from one industry to another and in relation to companies in the same industry. In relating these risks to marketable securities, investors are willing to pay a higher price in relation to earnings for defensive securities such as banking and food stocks which have records of stability as well as moderate growth than, for example, stocks in the hazardous aerospace industry which at the present time are selling at very low price/earnings multiples in relation to the stock market in general.[4] In valuing the stock of a close corporation in the Estate of H. J. Johnson, the court recognized that the company was subject to unusual hazards in its manufacturing operations and that this factor should be weighed in placing a value on the stock.[5]

Cyclical aspects and dependence on one or a few products are important risk factors to be considered by the appraiser as well as the maturity of the industry and the established position of the company being studied. Consideration should also be given to the company's competitive position and the potentiality of new competition as well as the relative ease to which new companies may enter the field and the amount of capital required. When large investment is required, the potential of competition may be small. However, an industry that requires only a small amount of capital and little technical knowledge enhances the potential of competition. In addition, some companies possess competitive advantages because of modern buildings and equipment, superior management, and being close to an abundant supply of labor, raw materials and markets. A company may be in a growing industry but its own prospects may be poor because it lacks these characteristics.

Evidence from the courts also indicates that the nature and history of the business are factors to be weighed by the appraiser in arriving at fair market value. In the Estate of James Smith it was noted that the future prospects of a business have an important bearing on the value of its shares.[6] Similarly, in the Estate of Cora R. Fitts, the court considered the nature of the business and its position in the industry in valuing the stock of a dry goods company that was in a period of declining sales and earnings.[7]

<u>Economic Outlook</u>

As a valuation factor, the economic outlook is an important consideration as evidenced by the following language from Revenue Ruling 59-60:

> "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."[8]

Graham and Dodd list the basic components in common stock valuation as fourfold:

1. expected future dividends
2. expected future earnings
3. capitalization ratio of the dividends and earnings
4. asset values[9]

Such a valuation procedure must take into account projections and expectations for the future. Similarly, in valuing closely held stocks an informed judgment must also weigh the prospective future performance of the company. This factor was recognized by the Court of Appeals in the recent case of the Estate of J. L. Snyder v. U. S. in concluding that investors buy close corporation stock "out of reasoned hope for the future, not out of pride in the past."[10]

In discussing the historical aspects of industrial booms and depressions, Dewing points out that it is important to consider that there have been booms and panics, periods of prosperity and periods of depression since the beginning of what we can discuss as detailed economic history.[11] It is important for the appraiser to consider that economic depressions have varying effects on different types of businesses. For instance, the retailer, dealing directly with the consumer, is generally the least effected by prolonged economic recessions. For instance, the retail merchant will normally, to the extent possible, convert his inventory into money first to satisfy his creditors and not begin to buy from the wholesaler until his goods show signs of depletion, and in turn the wholesaler does not purchase from the manufacturer until his inventory shows signs of needing replenishment. In brief, the closer a business is to the raw materials, the more it is affected by the economic cycle.

As an additional example, another obvious characteristic of economic activity is that a business selling or producing necessities is not as likely to experience the decline in volume as a business handling luxuries. Similarly, price is a factor affecting activity. Even though a commodity may be considered a necessity, it is not as likely to be purchased during a period of depression if the cost is too great. Thus a producer of five cent items is likely to suffer less in a period of economic decline than a producer of higher priced goods.

Financial Condition

Revenue Ruling 59-60 requires that the representative of the estate submit with the valuation comparative annual statements for two or more years immediately preceding the date of appraisal. The ruling points out that the following factors should be considered in appraising the financial strength of the company:

1. liquid position
2. gross and net book value of fixed assets
3. working capital
4. long-term indebtedness
5. capital structure
6. net worth[12]

The balance sheet presents a still picture of the financial condition of the company at a given time. In addition, by studying a series of statements covering an extended period of time the appraiser is in a better position to observe patterns and trends developing from a wide range of causes. His task is not only to analyze the financial position on a specific date, but also to get the feel of the previous financial pattern, which, in turn, should provide some clues to the future.[13] The direction in which the company is headed, of course, is often of greater importance than its financial condition as of a given date.[14]

The working capital position is of major interest to the appraiser since it is the basic test of liquidity. The adequacy of working capital can vary considerably depending on the nature and size of the business. In many lines of business a low current ratio may be satisfactory while in others the same ratio may be far from adequate. It is also of prime importance to determine not only the quantitative current ratio but also the quality coverage as well. The soundness of current assets is determined by liquidity, or the rate which inventories, receivables and other assets are turned into cash. The higher the liquidity, the higher the volume of business that can be supported by a given quantity of current assets.[15] If it is determined that working capital is inadequate and additional funds are required to maintain a proper cash position, a lower valuation should be placed on the capital stock of the company.[16]

Working capital is the primary source of financial strength of a company, and fixed assets are generally looked upon as secondary. In many cases there is no significant relationship between book values and the market values or earning power of plant and equipment. More significant to the appraiser is whether additional capital investment is required to maintain or increase the current level of earning power. If additional capital is required, the valuation should reflect this factor in reduced value.[17]

Another important consideration in determining the financial condition is an evaluation of the capital structure. The capitalization of a business may be represented by funded debt, preferred stock, common stock and surplus. While the use of debt is not always a disadvantage to common stock holdings,[18] a company with only a common stock capitalization generally offers a more attractive medium of investment than one with prior issues outstanding. With funded debt, the appraiser must give consideration to fixed charges coverage over a period of years with attention given to minimum coverage requirements and the possibility of default. Obviously, the thinner the margin of safety as represented by the owners' interests in the business, the more hazardous his position and such stock should be discounted for this higher degree of risk.[19]

Careful analysis of a company's financial statements requires more than a simple computation of book value, and in many cases the courts have given greater weight to the financial condition of the organization apart from book value in arriving at a fair market value figure.[20]

Earning Capacity

> "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 guides as to future expectancy..."[21]

Whenever possible, detailed profit and loss statements should be obtained and considered for a representative period prior to the appraisal date, normally at least five or more years. The length of the period studied will depend on the factors in each valuation. In any case, it should be long enough to provide an accurately detailed analysis of the company's operation and an indication of any trends concerning the future profits of the business. If, for example, a trend of declining or increasing earnings is found, greater weight should be given to the more recent years in estimating earning power.

Certain adjustments may be required by the appraiser in determining the true earnings picture of the business. Non-recurring items of income and expense, changes in accounting methods, reasonableness of officer salaries, depreciation deductions, long term debt expense, and capitalization of certain expenditures are a few examples. Major categories of cost and expense should also be carefully analyzed, particularly in the case of marginal producers. In analyzing the income statement, the appraiser should be aware, however, that it is an historical record of the past and that because of interest in the future, it must be recognized that changing conditions will alter its significance.[22] Further refinement by relating assets to future return in an effort to determine present value also deserves consideration by the appraiser. In addition, consideration may be given to the theory of various cost of capital concepts in arriving at values.

The significance of earning capacity is a major consideration in almost every case in the valuation of closely held stocks and the difficult problem of placing a value on earnings will be discussed in the succeeding chapter. Perhaps this consideration by the courts is best summed up by Judge Opper's opinion in the valuation of Prudential Insurance stock stating: "Indeed the value of corporate shares is probably in the end determined by what income they will fetch than by any other consideration."[23]

Dividend Capacity

Revenue Ruling 59-60 recognizes that consideration should be given to the dividends actually paid in the past.[24] A significant change over Revenue Ruling 54-77 is that recognition must be given to the necessity of retaining a reasonable portion of profits in a business to meet competition and future expansion.[25] In the past no specific recognition had been given to the greater need for closely held companies to retain earnings than for publicly held companies.[26] A closely held company can seldom expect to obtain outside equity financing as readily as publicly owned companies and thus must rely primarily on retained earnings or debt financing.

H. G. Guthmann points out six chief factors that should be weighed for judging dividend possibilities:

1. the presence of retained earnings not subject to restrictions
2. the amount of net profits for the preceding or current period
3. the condition of working capital
4. the stability of earnings
5. plans for expansion or contraction
6. the temperament of the directorate[27]

When valuing a controlling interest in a corporation, Revenue Ruling 59-60 and the courts recognize that the dividend payout may not be a material factor since the payment of such dividends is discretionary with the majority stockholders.[28] The majority owners may substitute salaries for dividends, or they may keep the payout low simply to avoid taxes on the dividend receipts. Accordingly, it follows that dividends may be a less reliable criteria of fair market value than other factors.[29]

While emphasis in most cases should be based on capacity rather than actual dividends paid, one notable exception is in valuing the shares of a minority interest. The courts have recognized the importance of dividends to a minority holder and concluded that the prospect of continuing dividends tempered the effect of a minority holding.[30]

Good Will

Revenue Ruling 59-60 considers good will as one of the relevent factors to be considered in arriving at fair market value.[31] One difficulty in appraising this factor, as borne out in court decisions,[32] is the problem of defining the actual meaning of good will or whether it actually even exists.[33] The Ruling states that the presence of good will and its value rest upon the excess of net earnings over and above a fair return on the net tangible assets. As early as 1810, Lord Eldon defined good will as "nothing more than the probability that old customers will resort to the old place".[34] Guthmann, in reference to good will states:

"Good will, then, where it exists, might be defined as the capitalized value of earning power in excess of the normal return on the net investment in tangible property."[35]

Badger contends that good will actually does exist under some conditions, pointing out that undoubtedly there is an intangible element of value present to a varying degree in different concerns to which earning capacity must be attributed.[36] He defines good will as a composite of those intangible elements of a business arriving out of reputation, organization, or location, which enable that business to enjoy greater earnings than would be enjoyed without them. In valuation cases, Badger considers good will as an equalizing factor, raising the book value of assets (by adding good will) sufficiently to make the rate of return on the increased value of book assets equal to a normal return for the industry. If earnings for the business were below the normal rate, no good will would appear.

There are at least three standard methods of capitalization of good will as used by the Commissioner in valuation cases,[37] briefly described as follows:

1. Straight Capitalization Method. - Average net profits are capitalized at a definite rate, as for example, 10% or 15%, and the result is considered as the total value, including both book value and good will, or tangibles and intangibles.

2. The Income Tax Method. - Under this method a certain percentage, as for example, 8%, is allowed on the net tangibles, this amount is deducted from the average net profits, and the remaining amount is capitalized at a fixed rate, as, for example, 10%, and added to the value of the net tangibles, the resulting total being the value of the stock.[38]

3. The Years' Purchase Method. - Under this method, which has been largely followed by the states, a return of 6% is allowed on the book value, or net worth, and this return is deducted from the average profits. The remaining profits are then multiplied by three or five, depending upon whether a "three years' purchase" or a "five years' purchase" of the good will is considered as the basis, and the good will is arrived at by this method. The good will so determined is then added to the book value or net worth, in order to determine the total value of the stock.

It should be noted that the above are considered as methods of valuing good will. The fact is, however, there is no rule for such valuation.[39] While the element of good will 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.[40]

Of significant importance in valuing small businesses is the consideration given to good will by the courts when the decedent was a major factor in management. In the case of Lawton v. Commissioner the court said:

> "Good will does not attach to a business or a profession, the success of which depends on the

> personal skill, ability, integrity, or other personal characteristics of the owners. 'Ability, skill, experience, acquaintanceship, or other personal characteristics or qualifications do not constitute good will as an item of property.'"[41]

Accordingly, the greater the interest of the decedent in managing business, the less the good will may be worth.

Summary

This chapter focused on outlining in general the major factors to be considered in valuing stocks of closely held corporations. The factors considered, although not all inclusive, are the major considerations set forth in Revenue Ruling 59-60 as being fundamental and require careful analysis in each case. Each of the factors discussed should be considered and given appropriate weight. In most cases, the greatest weight to any one factor will depend on the circumstances. A factor given considerable weight in one situation may warrant little or no consideration in another. It is important to know, however, reasons for their influence under various conditions, and the information they provide is necessary for an intelligent valuation in any case.

FOOTNOTES

CHAPTER III

1. Revenue Ruling 59-60, IRB 1959-1, CB 237

2. For a further discussion see Dawne, Fuller and Calkins, Investments, John Wily & Sons, Inc., New York, 1961, pp. 34-44

3. C. J. Schwingle, "Valuation of Closely Held Stocks", Trusts and Estates, June, 1961, p. 556

4. Clark, Dodge & Company, "Industry Review Summary", New York, November, 1964, pp. 1-10

5. H. J. Johnson et al v. Commissioner, 51F 2d, 1075

6. Estate of James Smith v. Commissioner, 134F 2d, 578

7. Estate of Cora R. Fitts v. Commissioner, P-H T.C.M. para. 55, 269

8. Revenue Ruling 59-60, op. cit.

9. Graham & Dodd, Security Analysis, McGraw-Hill Book Co., Inc., New York, 3rd Ed., 1951, p. 410

10. Estate of J. L. Snyder v. U. S., 182 F, 8199

11. Arthur S. Dewing, The Financial Policy of Corporations, Ronald Press Company, New York, Vol. I, 1953, p. 714

12. Revenue Ruling 59-60, op. cit.

13. The Credit Department, A Training Ground for the Bank Loan Officer, Robert Morris Associates, Philadelphia, 1946, p. 84

14. Davis & Gee, Analyzing Financial Statements, American Institute of Banking, New York, 1948, p. 105

15. Davis & Gee, op. cit., p. 105

16. Ralph E. Badger, Valuation of Industrial Securities, Prentice-Hall, Inc., New York, 1925, p. 129

17. C. J. Schwingle, op. cit., p. 556

18. For a discussion see Graham & Dodd, op. cit. Chapter on "Leverage"

19. Ralph E. Badger, op. cit., p. 127

20. See Estate of S. E. Holmes, 22 BTA 757; J. D. McDermott, 12 TCM 481; Estate of P. M. Vandenhouk, 4 TC 175

21. Revenue Ruling 59-60, *op. cit.*

22. H. G. Guthmann, *Analysis of Financial Statements*, Prentice-Hall, Inc., New York, 1953, p. 247

23. Estate of Leon N. F. Blanchard v. Commissioner, P-H T.C.M. para. 49,292

24. Revenue Ruling 59-60, *op. cit.*

25. Revenue Ruling 54-77, IRB 1954-1, CB 187

26. John B. Weed, "Valuation Rules Changed", *Trusts and Estates*, April, 1959, p. 312-15

27. H. G. Guthmann, *op. cit.*, p. 238

28. Estate of A. H. Stearns, 1 BTA 1252

29. Ralph E. Badger, *op. cit.*, p. 110

30. Estate of J. Helmers v. Commissioner, 9 T.C.M. 524

31. Revenue Ruling 59-60, *op. cit.*

32. See Jacob Mertens, *The Law of Federal Gift and Estate Taxation*, Lofet Publications, Inc., Sangertus, New York, Vol. I, 1959

33. Arthur S. Dewing, *op. cit.*, p. 285

34. Cruttwell v. Lye, 17 Vesey, 335

35. H. G. Guthmann, *op. cit.*, p. 145

36. Ralph E. Badger, *op. cit.*, p. 151

37. Commerce Clearing House, *Federal Estate and Gift Tax Reports*, New York, Val. I, 1964, p. 1495-96

38. This method, better known as A.R.M. 34 formula, will be discussed in more detail in the subsequent chapter.

39. Estate of Fisk, 1 BTA 882

40. Revenue Ruling 59-60, *op. cit.*

41. Lawton v. Commissioner, 6 T.C. 1093

Chapter IV

VALUATION METHODS

In the past, five principal methods have been used in valuation cases. Each of these methods is of particular interest and will be discussed along with several less frequently used methods.

Book Value

The Internal Revenue Code and Revenue Ruling 59-60 require that "all relevant factors" are to be considered in arriving at fair market value and, accordingly, in each case consideration must be given to book value and what weight, if any, should be given to this factor.[1]

Graham and Dodd, in discussing the fourfold basic components in a common stock valuation states that the asset value per share - in terms of both tangible assets and of net current assets alone - may affect the final valuation in somewhat exceptional cases, however, book value is a minor factor in most valuations.[2] In a majority of cases book value represents neither market value nor the true value of the assets of a corporation.[3] From an accounting standpoint, assets are normally carried at their cost less depreciation and there is generally no true relationship between their value as carried on the books of a company and their true worth. Accordingly, except in cases where liquidation is intended, many authorities conclude that book value should be considered significant only as it relates as a contributor to future earning power.[4]

While book value is but one factor to be considered, too often both appraisers and the Internal Revenue Service agents simply attempt to settle a stock's value at its book value.[5] K. J. Bushman states that Revenue Agents, being burdened with a heavy volume of work, often will take the least laborious method of valuation and propose that stock be valued at its book value, at the exclusion of other factors, particularly if such value would result in a higher figure than if earnings, dividends, and other factors were taken into consideration.[6]

In relating book value to marketable securities, it appears that asset values have little, if any, influence on their market prices.[7] In the early 1900's great significance was attached to book value, however, prior to World War I emphasis apparently shifted to earning power. In a study covering the relationship between the market values and book values of twenty-one representative concerns for the period 1915 to 1921 book value as a percentage of market value ranged from a high of 70% in 1915 to as low as 36% in 1920.[8] In 1955, a study of the relationship of 1053 common stock prices to book value revealed that none were selling at book value; 42% were above book value; and 58% were below book value. Percentage ranged from 32% for Armour & Company to 688% for International Business Machines.[9] Similarly, a study made in 1958 of all common stocks on the New York Stock Exchange on a particular day revealed that book value as a percentage of market value ranged from a minimum of 11.3% to a maximum of 527.1%.[10]

Even with the stock market currently at record high levels, numerous common stocks are selling at well below book value. In a recent study Standard & Poor's lists fifty-four stocks on the New York and American Stock Exchanges that were not only selling at prices well below book value but also at prices at close to equity in working capital.[11] The study points out that there are generally good reasons for the market to place a low appraisal on a company's assets; the company may not be deriving the maximum results from its resources, or the industry outlook is unfavorable, or the company's record is unimpressive. On the other hand, a strong asset position affords some protection against financial difficulty and also becomes a plus factor if favorable earnings develop.[12]

In relating book value to market value, the courts have in some cases settled on book value,[13] but have generally recognized that it is but one factor to be considered.[14] In rejecting book value as a basis of valuation for a manufacturer of specialized machinery, the court, in the case of Kershaw Manufacturing Company, Inc., said:

> "...The book value for assets is often at some variance with the actual or market value of assets, and a calculation based thereon is subject to considerable error."[15]

Since many stocks sell at only a fraction of book value and others at a figure much higher, it is apparent that asset values are only one factor to be considered and should not be overemphasized - particularly if fair market value is probably a lesser figure.[16] It should be noted, however, that asset values may be highly significant for companies having highly liquid assets such as financial companies or in many cases for personal holding companies.

Appeals Review Memorandum - 34 Formula
(Better Know as A.R.M. - 34)

Before the issuance of Revenue Ruling 54-77, A.R.M.-34 was accepted by agents as descriptive of the method of valuing closely held stock.[17] It was apparently common policy for an agent to compare book value with a value arrived at by applying his interpretation of A.R.M.-34 and then insisting upon a figure falling within the range established.[18]

In establishing the "Years' Purchase Formula" or A.R.M.-34, the Appeals Review Committee in 1920 provided the following:

> "The method is to allow out of average earnings over a period of years, preferably not less than five years, a return of 10% upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets,and it is the opinion of the Committee that this return should be capitalized upon the basis of not more than five years' purchase, that is to say, five times the amount available as return from intangibles should be the value of the intangibles....
>
> "The foregoing is intended to apply...to...businesses of a more or less hazardous nature. In the case, however, of valuation of good-will of a business which consists of the manufacture or sale of standard articles of every day necessity not subject to violent fluctuations and where the hazard is not so great, the Committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10% to 8% or 9% and that the percentage for capitalization of the return upon intangibles might be reduced from 20% to 15%."[19]

There are many variations of the application of the formula, such as:

1. using a longer average period than five years, if the shorter period appears not to reflect fairly normal earning power
2. using a higher rate of return than 10% on tangibles if it can be demonstrated that other similar companies do in fact show an average return of say 15% or 20%
3. Omitting entirely from the average earnings one or more abnormal years[20]

A.R.M.-34 was an attempt to simplify the valuation problem by the application of a formula. It varies from a straight capitalization of earnings by separating earnings into those attributable to tangible assets and those attributable to intangible value on the excess over a fair rate of return. A simple application of the formula is given in Table III.

Many cases have been decided by the court based on A.R.M.-34 and variations of this formula.[21] Capitalization rates as determined may vary in such cases from a low of 6% on tangibles to 35% on intangibles. In an analysis of court decisions, Mertens gives the following as averages: non-hazardous business - 8% on tangibles; 15% on intangibles; hazardous business - 10% on tangibles; 20% on intangibles.[22]

A.R.M.-34 presents a number of uncertainties in arriving at value, such as the judgment of the value of tangible assets, the rate of return on tangibles, a representative period of time for earnings coverage, and the rate of capitalization on intangibles which will depend, among other things, on: the general business picture, the specific industry, and the risks and problems incident to the specific business.[23]

TABLE III

VALUATION OF A CLOSELY HELD STOCK BY A.R.M.-34 FORMULA

Basis for Computations

Number of shares outstanding	10,000
Cost of capital rate on tangible assets	10%
Cost of capital rate on intangible assets (good will)	15%
Average tangible assets value 1959-64	\$500,000.
Average earnings 1959-64	\$ 70,000.

Computation of Value

Normal earnings on tangible assets (10% of \$500,000)	\$ 50,000.
Excess earnings on intangible assets (\$70,000 - \$50,000 capitalized at 15%)	\$133,333.
Total assets value (\$500,000 + \$133,333)	\$633,333.
Value per share of stock (\$633,333 ÷ 10,000)	\$ 63.33

Capitalization of Earnings

The Internal Revenue Service in many cases insists that capitalization of earnings is the proper approach in valuing closely held stocks.[24] Revenue Ruling 59-60 recognizes, however, that the determination of an appropriate capitalization rate presents one of the most difficult problems in valuation. Price/earnings ratio of listed securities will show wide variations even for companies in the same industry. In addition, the ratio will fluctuate from year to year depending upon economic conditions.[25] Accordingly, the Ruling recognizes that no standard rates of capitalization applicable to closely held corporations can be formulated.[26]

It is the opinion of many experts that in the valuation of common stocks earnings should be considered as the most significant factor.[27] Various formulas have been developed in the past to determine price/earnings ratios.[28] The two basic facts to be considered are (1) the number of years to be used in determining average net profits and (2) the capitalization rate for these earnings. In many cases the period of years selected will be a vital factor in ultimate value and the selection of the multiple or capitalization rate is perhaps the most difficult task.[29] Any figures the appraiser arrives at will always be basically a matter of judgment. Paul E. Orr, Jr., in a critical discussion of the capitalization of earnings method for valuing closely held stock points out the following as some of its shortcomings:

> "... a widespread practice is to take earnings over a five-year period. Why not ten or three or some other period? Earnings over the last five years might happen to be most representative of future earnings but could be entirely misleading. For a 'dying industry' hard hit by competing technological advances, they could be meaningless. For a group of fast growing electronic companies, earnings of the most recent one year period might be far more significant."[30]

Some experts are of the opinion that in arriving at a capitalization multiplier for closely held securities the multiplier should be related to the price/earnings ratios of marketable securities. This approach is related to the comparison with similar businesses method of valuation which is discussed in the following section of this chapter. Ralph Badger concludes from his study that there is an assumption that similar industry securities must sell on approximately the same terms.[31] He states that it is unreasonable to suppose that two common stocks, with essentially the same risk factors present, would capitalize earnings at widely different ratios. In the present day market this is also perhaps a reasonable assumption. Nevertheless, as noted in Revenue Ruling 59-60, price/earnings multiples for some companies in the same industry may vary widely. For example, in the air conditioning industry Trane Company is currently selling at approximately 20 times 1964 earnings per share while Carrier Corporation is selling at 12 times earnings. Among the international oil companies Texaco, Inc. is selling at 17 times earnings as compared to 11 for Royal Dutch Petroleum and among the chemical stocks E. I. duPont is 29 times earnings in contrast to 15 times for Stauffer Chemical Company. Accordingly, it is apparent that in determining capitalization rates factors other than the nature of the business and its industry group must also be considered.

In determining capitalization rates, appraisers should also recognize that for marketable securities the capitalization rates for earnings have fluctuated widely over past periods of time and will undoubtedly continue to do so in the future.[32] In relating these rates to closely held stocks it should be recognized that fluctuations in the stock market as well as general business conditions may not bear a close relationship to the value of a small business.[33] Consideration should also be given to the fact that stocks have not always been successfully evaluated by the market in estimating future earning power.

In an interesting study of the correlation between price/earnings ratios and price and earnings change made by Drexel and Company, as reflected in Table IV, the ten lowest price/earnings stock in the Dow-Jones Industrial Average outperformed the ten highest price/earnings stocks for the four year period to December 31, 1963. While the average price performance of the stocks was approximately the same, the earnings of the low price/earnings stocks increased over twice the amount of the high price/earnings stocks. Similarly, in a widely quoted study on

TABLE IV

COMPARISON of DJIA 10 LOWEST with
10 HIGHEST P/E RATIO STOCKS
as of 12-31-63

	P/E Ratio Closing Prices		% Increase 1960-1963		1963 Dividends ÷ 1963 Closing Price
10 Lowest P/E Ratios	1960	1963	Earnings	Price	
Chrysler	11.1x	9.7x	+383.3	+320.0	1.0%
General Motors	12.2	14.2	+ 66.0	+ 92.7	5.0
Int'l Harvester	13.6	14.1	+ 25.3	+ 39.5	4.0
Bethlehem Steel	15.8	14.7	- 16.3	- 22.5	4.8
Standard Oil Calif	11.5	13.3	+ 17.8	+ 36.4	3.0
Anaconda	10.2	11.6	- 3.7	+ 9.1	5.2
Woolworth	14.3	14.1	+ 8.7	+ 5.8	3.7
American Tobacco	14.2	11.2	+ 10.1	- 15.2	5.4
Johns Manville	18.4	15.0	+ 4.2	- 14.0	4.1
United Aircraft	19.3	15.1	+ 60.0	+ 16.2	4.7
	13.7x	13.1x	+ 28.1	+ 22.7	4.1%
	Ex Chrysler		+ 17.3	+ 15.4	
10 Highest P/E Ratios					
Int'l. Paper	18.4x	21.6x	- 8.1	+ 6.7	3.4%
du Pont (1)	23.1	27.7	+33.5	+57.9	3.2
Proctor & Gamble	26.0	29.1	+ 3.8	+15.9	2.0
Union Carbide	22.7	22.6	+ 1.3	+ .8	2.9
General Electric	33.0	29.0	+32.7	+17.6	2.3
Westinghouse	22.2	26.6	-42.3	-30.6	3.5
General Foods	26.4	26.8	+24.5	+26.8	2.2
Sears, Roebuck	22.3	29.3	+31.4	+71.9	1.7
A T & T	19.3	23.3	+ 9.6	+31.8	2.2
Eastman Kodak	33.9	33.9	+13.6	+13.4	2.0
	24.3x	26.9x	+12.9	+24.9	2.6%

(1) du Pont adjusted to include only 1/2 share GM common reflecting distributions in 1962 and 1963.

Source: Determination of Price-Earnings Ratios, an address by Albert Y. Bingham before the Midwest Forum of the Investment Analysts Society of Chicago on March 19, 1964 price/earnings ratios by S. Francis Nicholson, the author made a study of 100 institutional stocks covering the years 1939-1959 which reflected that the twenty lowest multiple stocks showed more appreciation than the twenty highest.[34]

The courts have used average earnings over different periods of years, generally ranging from two to ten, at various capitalization rates adjusted for the trend of earnings, economic conditions, and numerous other factors.[35] It is important, however, to consider that earning power is only one factor in valuation along with other relevant factors,[36] and a valuation should not be based on an arbitrary capitalization of earnings.[37] The significance of earnings in valuation cases is perhaps best summed up in the language of a 1943 court decision as follows:

> "Net earnings are important but they are only one of many factors upon which value of shares may be considered, and the significance to be given to such figures depends upon the evidence of all the circumstances in which they are found. Without knowledge of the setting in which the earnings appear, they lack substantial evidentiary forces from which a useful inference of fair market value can be drawn. Furthermore, it would be entirely unwarranted for the Board, without evidence supporting it, to select a multiple of average earnings as the basis for a finding of fair market value."[38]

Comparison with Similar Companies

The use of comparable securities as a basis for determining fair market value was first officially recognized by amendment to the Revenue Act of 1943, and was subsequently incorporated in the Internal

Revenue Code of 1954. The Code states that in stock valuations consideration shall be given to the value of stocks of corporations engaged in the same or a similar line of business which are listed on an exchange.[39] This language was also included in the Internal Revenue Ruling 54-77.[40] The major shift in emphasis to the comparative approach, however, was made in Revenue Ruling 59-60.[41] This apparently indicated a change in thinking on the part of the Internal Revenue Service and strengthened the comparative approach.[42] Revenue Ruling 59-60 states that the best measure of valuing a closely held stock in many instances "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."[43] The Ruling also goes a step further in including stocks traded in the over-the-counter market as well as those listed on an exchange for comparative purposes.

The comparative approach to valuation has been recognized by many authorities as the most logical method of appraising the stocks of closely held companies. In 1945 Douglas Van Dyke, in his critical analysis of valuations by the Internal Revenue Service reached the following conclusion:

> "The comparative method of valuation of stock in a close corporation is obviously the only method of obtaining the equivalent of a fair market value for such a stock on a given date, that it should be applied whenever the necessity of obtaining the fair market value of such stock arises..."[44]

C. J. Schwingle, President of the American Appraisal Company and a prominant specialist in valuing closely held securities, states that most significant in investigations for tax valuation is the assembly of statistics for comparable or near comparable companies whose stock is actively traded.[45] Since the market prices of publicly traded securities are influenced by their capital, earnings, and dividends, it should follow that perhaps the best way of determining a value for a closely held stock is by comparison with publicly traded stocks having similar degrees of business and financial risks.[46]

In using the comparative approach to valuation Revenue Ruling 59-60 limits companies to "corporations engaged in the same or a similar line of business".[47] This presents to the appraiser the difficult problem of finding suitable publicly-owned companies to be used for comparison.[48] The companies selected should be of a nature that investors would be inclined to group them together along with the closely held stock. They should be similarly affected by business conditions, show approximately the same general trend of sales and earnings, and have basically the same problems, markets and methods of doing business.[49] In the selective process, all companies should be eliminated that are significantly dissimilar to the closely held stock in order that only a homogenous group of companies are used for comparison.

After the difficult selection of comparable companies has been made, statistical data concerning the companies with regard to numerous factors such as book value, net working capital, earnings, dividends, as well as future prospects of the industry, economic conditions, and so forth may be related to the closely held stock. These tests applied separately may give a wide range of approximate values for the closely held stock. A simple illustration of applied statistics using the comparative approach is given in Table V, taking into consideration that there are numerous other factors and statistics that may apply in a given valuation. This illustration gives an average value of $99.20 per share for the stock of the closely held company, which may be meaningless, or values ranging from a high of $114.00 to a low of $85.71.

Some factors may be more meaningful than others in a comparative appraisal, and other factors may be helpful only in supporting or modifying the factor given the greatest weight. In a given case earnings factors may prove to be the most significant. In 1944 in the Estate of Fredrick Webb the court favored the comparative approach using the price/earnings ratio in relation to the comparative stocks, with the value arrived at adjusted upward for such factors as capital structure, debt position, asset values, and quick asset ratio, all of which, in the opinion of the court, represented conditions more favorable to the closely held stock than to the comparatives.[50] Similarly, in 1953 the court determined a value by comparison with 19 listed stocks

TABLE V

VALUATION BY THE COMPARATIVE APPROACH

Statistical Relationship of a Closely Held Stock to Comparable Listed Stocks

	Book Value	5-Yr. Avg. Earnings	1964 Earnings	5-Yr. Avg. Dividends	1964 Dividends
Company #1	$33.00	$2.25	$2.60	$1.10	$1.40
Company #2	35.00	2.50	3.00	1.20	1.60
Company #3	15.00	1.15	1.50	.50	.75
Closely Held Company	85.00	6.00	5.75	2.50	3.00

Statistical Relationship to Market Price of Comparable Stocks

	Market Price 4/1/65	Price/Book Value	Price X 5-Yr. Avg. Earnings	Price X 1964 Earnings	Yield on 5-Yr. Avg. Dividends	Yield on 1964 Dividends
Company #1	$35.00	106%	16.00	$14.00	3.1%	4.0%
Company #2	45.00	129%	18.00	15.00	2.7%	3.6%
Company #3	25.00	167%	22.00	17.00	2.0%	3.0%
Averages		134%	19.00	$15.00	2.6%	3.5%

Average Statistical Relationship to Closely Held Company Stock

Price/Book Value	=	134% of 85	=	$113.90
Price X 5-year average earnings	=	19 X 6	=	114.00
Price X 1964 earnings	=	15 X 5.75	=	86.25
Price X 5-year average yield	=	2.50 ÷ 2.6%	=	96.15
Price X 1964 yield	=	3.00 ÷ 3.5%	=	85.71
		Average		$ 99.20

and gave the greatest weight to the price/earnings ratio along with dividends.[51] In 1960, the court ruled in an interesting case involving the valuation of the stock of Coca Cola Bottling Company of Charlotte, North Carolina, where both the taxpayer and the Internal Revenue Service used the comparative approach relying mainly on earnings.[52] The taxpayer valued the stock at $2,848.64 per share by comparison with Coca Cola Bottling Company of Los Angeles, Coca Cola Bottling Company of New York and Pepsi Cola General Bottling Company. The Internal Revenue Service arrived at a value of $5,653.56 by comparison with the market value of Coca Cola Bottling Companies of Chicago, St. Louis, and Cincinnati. Both sides felt the companies they selected were more comparable to the stock being valued, however, the court disregarded both and arrived at a value of $4,150. per share by using a straight capitalization of a five-year average earnings capitalized by 10 and discounting this figure by 10% for lack of marketability. This case points out one of the major shortcomings of the comparative approach in that there may be a tendency on the part of the appraisers to select "comparable" companies to justify their own conclusions rather than being purely objective in their selections.[53]

Restrictive Agreements

It has been pointed out that the problem of valuing closely held stock is a difficult and uncertain task. As a result, in many instances an attempt is made during the lifetime of the decedent to fix the value of the stock for tax purposes through a restrictive agreement. Moreover, a study of the Regulations covering restrictions on the transfer of stock suggests that Revenue Agents are encouraged to accept the values that are fixed in an agreement for the sale of a closely held stock from an estate.[54] Concerning restrictive agreements the position of the Internal Revenue Service is stated in Revenue Ruling 59-60 as follows:

> "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....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 the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a 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."[55]

On the basis of various court decisions it appears that the value of a closely held stock as set forth in an agreement will be determinative for estate tax purposes if the following conditions are met:

1. The agreement is the result of an "arm's length" transaction.
2. The agreement requires the estate to sell.
3. The surviving party or parties have a legally binding contract or option to purchase.
4. The decedent could not have disposed of his interest during his lifetime without first offering it to the other party at a price not higher than the price to be paid had the sale been made by his estate to such other party.[56]

Leading authorities generally agree that if the foregoing tests are met, the price fixed in the agreement is usually accepted as fair market value for estate tax purposes.[57] George J. Laikin points out that if the tests are met, the fact that the value fixed by the agreement is less than the fair market value at the time of death is immaterial.[58]

The preparation of restrictive agreements constitutes the practice of law and is not a matter for the investment appraiser. Such an agreement requires consideration of numerous legal questions and should be prepared by an attorney representing the interested parties who has examined all the facts. A simple specimen agreement which should meet the requirements of the Internal Revenue Service in fixing a valuation for estate tax purposes is given in Appendix B.

Other Valuation Methods

The foregoing methods of valuation appear to be the most prevelant in estate tax cases. There are, however, numerous other methods of valuing common stocks advocated and used. One common method is the "intrinsic value" approach wherein an attempt is made to value a common stock independently of market prices with primary emphasis on future earning power.[59] Another method sometimes used in valuation cases, particularly by the New York State tax authorities is known as the "Foster Method" which is based upon a New York Court of Appeals case.[60] Using this method average earnings for a reasonable length of time are capitalized at a rate dependent on the hazards of the business, and a mean is obtained between that figure and book value.[61]

Another common method of valuation that has been used by the Internal Revenue Service is a formula approach weighing the computations on three separate values: one based on book value, one based on earnings and one based on dividends. For example, assume a stock has a book value of \$50.00 per share, average five-year earnings of \$4.00 per share which are capitalized at 10% giving a value of \$40.00, and average five-year dividends of \$2.00 per share capitalized at 6% giving a value of \$33.33. Then assuming a weight of three for book value, two for earnings, and one for dividends, the result would be as follows:

Book value of \$50.00	@ 3 =	\$150.00
Earnings value of \$40.00	@ 2 =	80.00
Dividend value of \$33.33	@ 1 =	33.33
Totals	6	\$263.33

\$263.33 ÷ 6 = \$43.89 value per share

In a study conducted at Princeton University this formula was applied to marketable securities with the results reflecting that any relationship between values arrived at by use of the formula and actual market values were purely coincidental.[62]

The observation may be made at this juncture that since valuations cannot be made on the basis of a prescribed formula mathematical weightings may be used as a basis for valuation or as a check on the method used. In discussing this consideration, Revenue Ruling 59-60 states that mathematical weightings cannot be assigned in determining fair market value and no useful purpose is served by taking an average of several factors and basing the valuation on the result.[63] Nevertheless, as pointed out in discussing the comparison with similar companies' approach, such a technique may be used and as such has been recognized by the courts.[64]

Summary

This chapter emphasized the five principal methods now existing for valuation of closely held stocks while recognizing that numerous other methods are advocated and used. Each of the methods discussed is of particular interest to the appraiser for certain types of valuation cases and all of the methods may be considered in any case before determining the final approach to be used. In earlier court decisions both the book value and A.R.M.-34 methods appear to have received the greatest influence. In recent years the shortcomings of these methods have apparently been recognized and more emphasis has been placed on earning power and the capitalization of earnings. Also, with Revenue Ruling 59-60 apparently strengthening the comparison approach, many authorities now recognize this method of being the most appropriate. In addition, when a restrictive agreement is made during the lifetime of the decedent and can be shown to be bona fide and "arms length", the price fixed will probably in most cases be held as establishing value.

FOOTNOTES

CHAPTER IV

1. Internal Revenue Code of 1954, Section 2512(a); Revenue Ruling 59-60, IRB 1959-1, CB 237

2. Graham and Dodd, Security Analysis, McGraw-Hill Book Co., Inc., New York, 3rd ed., 1951, p. 410

3. Ralph E. Badger, Valuation of Industrial Securities, Prentice-Hall, Inc., New York, 1925, p. 140

4. Arthur S. Dewing, The Financial Policy of Corporations, Ronald Press Company, New York, Vol. 1, 1953, p. 302; Guthmann and Dougall, Corporation Financial Policy, Prentice-Hall, Inc., New York, 3rd ed., 1955, p. 577; Ralph E. Badger, op. cit., p. 143

5. C. W. Hughes, "Valuation of Assets for Federal Tax Purposes", Trusts and Estates, May, 1956, p. 417; Paul E. Orr, Jr., "Market Approach to Market Value", p. 1012, Trusts and Estates, November, 1958; K. J. Bushman, "Valuation of Close Corporation Securities", Trusts and Estates, April, 1951, p. 228

6. K. J. Bushman, op. cit., p. 228

7. Graham and Dodd, op. cit., p. 188

8. Ralph E. Badger, op. cit., p. 144

9. C. J. Schwingle, "Valuation of Closely Held Stocks", Trust and Estates, June, 1961, p. 555

10. Paul E. Orr, Jr., op. cit., p. 1012

11. The Outlook, Standard and Poor's Corporation, May 25, 1964, p. 790

12. Ibid.

13. Estate of Edward H. Hanscom, 24 B.T.A. 173; Estate of Bozo Banac v. Commissioner, P-H, T.C.M., para. 17, 86; Roger W. Pope v. Commissioner, P-H T.C.M., para. 56,041

14. Estate of Samuel E. Montgomery v. Commissioner, P-H T.C.M., para. 53, 329; Celia Waterman v. Commissioner, P-H T.C.M., para. 61,225; Erwin D. Friedlander v. Commissioner, 26 T.C. 1005

15. Kershaw Manufacturing Company v. Commissioner, P-H T.C.M., para. 61,098

16. C. W. Hughes, <u>op. cit</u>. p. 417

17. Joseph D. Hartwig, "Valuation Problems Before the Internal Revenue Service and Tax Court", 13 N.Y.U. Institute of Taxation, 1955, p. 1143

18. A.R.M.-34, 2 C.B. 31

19. <u>Ibid</u>.

20. K. J. Bushman, <u>op. cit</u>., p. 229

21. See Howard B. Lawton v. Commissioner, 6 T.C. 1093; Estate of Henry A. Maddock v. Commissioner, 16 T.C. 324; Estate of George D. Helmers, P-H T.C.M., para. 50,154

22. Jacob Mertens, <u>The Law of Federal Gift and Estate Taxation</u>, Lofet Publications, Inc., Sangertus, New York, Vol. 1, 1959, p. 590

23. <u>Estate Plans</u>, Institute for Business Planning, Inc., New York, p. 15,412

24. John E. Stone, "Valuation of Closely Held Stocks", <u>Trusts and Estates</u>, February, 1956, p. 116; C. W. Hughes, <u>op. cit</u>., p. 417

25. Revenue Ruling 59-60, <u>op. cit</u>.

26. <u>Ibid</u>.

27. Arthur S. Dewing, <u>op. cit</u>., p. 287; Graham and Dodd, <u>op. cit</u>., p. 507; Robert H. Montgomery, <u>Montgomery's Federal Taxes</u>, The Ronald Press, New York, 35th ed., 1954, p. 680

28. For example, Graham, Dodd, and Cottle in the 1962 edition of <u>Security Analysis</u> discuss two formulas: one called the "Central Value Method" based on past and present earnings, and also a "Future Projection Method" based on future projections of earnings. Also see Joel H. Hirsch, "An Effective Yardstick of Common Stock Value", <u>The Analysts Journal</u>, May-June, 1961, pp 13-20

29. Ralph E. Badger, <u>op. cit</u>., p. 117

30. Paul E. Orr, Jr., op. cit., p. 1014

31. Ralph E. Badger, op. cit., Chap. XI

32. Graham and Dodd, op. cit., p. 507

33. Arthur S. Dewing, op. cit. p. 380

34. S. Francis Nicholson, "Price-Earnings Ratios", The Analysts Journal, July-August, 1960, pp. 43-5

35. See Commerce Clearing House, Federal Estate and Gift Tax Reports, Vol. 1, for citing of numerous cases based on capitalization of earnings

36. See Estate of E. D. Badger v. U. S., 172 F 833

37. Paul E. Orr, Jr., op. cit., p. 1014

38. Worcester County Trust Company, et al, v. Commissioner, 134 F 578

39. Revenue Act of 1943, Section 811 (K); Internal Revenue Code of 1954, Section 2031 (b)

40. Revenue Ruling 54-77, IRB 1954-1, CB 187

41. Revenue Ruling 59-60, op. cit.

42. For a discussion see John B. Weed, "Valuation Rules Changed", Trusts and Estates, April, 1959, pp. 312-14

43. Revenue Ruling 59-60, op. cit.

44. Douglas Van Dyke, "Commissioner Unfair to Fair Market Value", Taxes, September, 1945, p. 791

45. C. J. Schwingle, op. cit., p. 556

46. John B. Weed, op. cit., p. 312

47. Revenue Ruling 59-60, op. cit.

48. John B. Weed, "Techniques in Valuation of Close Corporations", 20 N.Y.U. Institute of Taxation, 1962

49. Paul E. Orr, Jr., op. cit., p. 1013

50. Estate of Fredrick Webb, 3 T.C.M. 440

51. Morris Miller v. Commissioner, P-H T.C.M. 53,155

52. Estate of J. L. Snyder, et al v. U. S., 182 F 71

53. Paul E. Orr, Jr., op. cit. The author points out that for the comparisons to have merit the companies must measure up to impartial and strict standards and specific companies should be eliminated from the list for specific and sound reasons.

54. George J. Laikin, "Survivor Purchase Agreements and Taxes", Trusts and Estates, October, 1958, p. 893

55. Revenue Ruling 59-60, op. cit.

56. Business Purchase Agreements Funded with Life Insurance, New York Life Insurance Company, New York, 1956, pp 34-35. This booklet cites numerous cases in support of these conditions including: Wilson v. Bowers, 57 F (2nd) 682; Lomb v. Sugden, 82 F (2nd) 166; Estate of George M. Trammell v. Commissioner, 18 T.C. 662; and Broderick v. Gore, 224 F (2nd) 892

57. Homer I. Harris, Handling Federal Estate and Gift Taxes, Baker Voores & Co., Inc., Mount Kesco, New York, 1959, p. 82; George J. Laikin, op. cit., p. 893; K. J. Bushman, op. cit., p. 234; Estate Plans, op. cit.; Commerce Clearing House, Inc., Federal Estate and Gift Tax Reporter, Vol. 1, p. 1,487

58. George J. Laikin, op. cit., p. 880

59. For a discussion see Graham & Dodd, op. cit., pp 404-05

60. Matter of Foster's Estate, 263, N.Y.S. 226

61. For a discussion of this method see Donald S. Willcox, The Trustee's Responsibilities with Respect to Close Held Corporations, The Stonier Graduate School of Banking, 1955, p. 67

62. Paul E. Orr, Jr., op. cit., p. 1014

63. Revenue Ruling 59-60, op. cit.

64. Estate of E. D. Badger v. U. S., 172 F 833

Chapter V

COST OF CAPITAL AS A VALUATION CONSIDERATION

Importance of Cost of Capital

Cost of capital has been used extensively in public utility regulation. However, court decisions used in this study do not reveal any use of this doctrine as a criterion for valuing closely held securities. Nevertheless, as noted by the following authorities, its importance is being well recognized and merits the consideration of the appraiser:

> "Cost of capital is in the air. The economists, both quantitative and institutionalist, are analyzing the concept; the lawyers have dealt with it even at the levels of the Supreme Court of the United States; the accountants now manifest an interest in it; and financial management must comprehend it in discharging the vital planning function in business enterprise."[1]

> "Corporate managers and financial analysts in search of new and improved methods of decision-making want to know what the 'cost of capital' is and how to use it. No more troublesome concept in finance exists, however, as evidenced by the vigorous debate of the meaning and measurement of the cost of capital now taking place among managerial economists and analysts."[2]

Cost of capital may be significant as a guide to establishing the minimum acceptable rate of return of a project and in assisting in the formulation of financing decisions which will result in an optimum capital structure. Decisions to invest by a corporation necessarily require a comparison of expected earning power to cost.[3] Accordingly, as a valuation consideration, it may be assumed that a corporation that knows its cost of capital will not purchase the assets of a closely held corporation at a figure that will not produce a rate of return at least equal to its cost of capital. Furthermore, as pointed out by Bowman, a lack of managerial competency on the part of the buying company is all too evident in the case of many mergers and acquisitions; therefore, unless the purchasing company feels it can do a better job of managing the assets of the selling company it may be reasonable to assume that the purchase price should be based on an anticipated rate of return higher than the buying firm's cost of capital.[4] Accordingly, the appraiser may consider cost of capital of similar companies as a check on the valuation approach used or perhaps even as a basis for the valuation.

Cost of Capital Defined

The term "cost of capital" has been used in many different ways and each different usage of the term may imply a different decision criterion for the allocation of a company's capital.[5] Harry V. Roberts points out that the phrase "cost of capital" has caused as much confusion as the expression "rate of interest" in the literature of theoretical economics.[6] The term has frequently been used in connection with specific forms of capital such as equity or debt. However, a company's cost of capital depends not only on the cost of equity and debt but also on how much of each kind of capital it obtains.[7] A firm's cost of capital is consequently also variable since it is a function of debt/capital ratio, dividend rate, rate of return on investment and other variables.[8]

Currently, it has become increasingly recognized that one cannot refer to the costs of specific types of capital in isolation.[9] For example, the cost of equity capital is influenced - at least to some extent - by the debt capital of the company and any higher equity cost resulting from debt financing may be regarded as a part of the cost of debt funds. Accordingly, cost of capital should be some weighed average of equity and debt funds. John F. Childs defines the term as: "The over-all net cost to a company to provide the return on all types of securities which investors require or anticipate to induce them to provide capital."[10] Another definition is: "The average cost of all items comprising the total capital funds of the business, weighed to give consideration to the dollar 'mix' of the elements."[11]

The average cost of capital as defined above indicates the minimum rate of return required in order for a project to be accepted, or the "cutoff" rate for capital expenditures. In short, the cost of capital may be considered as an opportunity cost concept that sets the minimum rate that the investment must promise to return.[12]

Components of the Cost of Capital

In many cases a capital investment for a firm will depend not only on the rate of return it promises but also on its cost of capital. If the investment is expected to offer a return higher than cost of capital, then it is worthwhile for consideration by management. In ranking capital expenditures by their rate of return or profitability index, a demand schedule for funds is constructed and it may be seen that increasing amounts may be invested at successively lower returns. In contrast, one can construct a supply schedule for capital funds showing increasing amounts available at successively higher costs.[13] Accordingly, it may be assumed that the costs of capital vary with the amounts and types of funds supplied. A firm's cost of capital is a function of the earnings rate, debt/total capital rate and/or other variables.[14] This, it is the total cost to a firm of all its long-term sources, including common stock, that must be considered and cost of capital must be approached from an entity point of view.[15]

The assumption is made that if, for example, the cost of debt financing is 5 percent and the cost of common stock is 10 percent then the debt rate is the cost of capital. However, in order to assume debt financing the firm must have an equity base that will permit additional debt. In using debt financing the firm will be using up some of its equity base and at some point in the future the firm will have to turn again to equity financing.[16] Thus the firm must be viewed as an on-going concern with cost of capital being a weighed average of all forms of financing which are used by the firm.[17] With this in mind, the major sources of long-term capital funds are considered.

The Cost of Common Stock

"The determination of the cost of common stock to an enterprise is one of the great financial problems of our times."[18] Deriving cost of capital from the issue of common stock is a most difficult concept and one about which little agreement exists in practice.[19] It is inexact simply because forecasts are required.[20]

Normally, we may expect management to further the interests of stockholders if investments lead to higher earnings per share assuming no change in the earning multiple as capitalized in the market. Thus one might say that any investment decision that results in increasing the market price of stock is a good one and, accordingly, the cost of new common stock would be price/earnings ratio per share. Unfortunately, the cost associated with raising equity capital has generally been expressed by earnings that would have to be generated by the new capital in order to prevent dilution of the per share earnings on existing common stock.[21] This is the method used by Weston who states that the price-earnings ratio is the best dependable basis for calculating the cost of common stock.[22] This method would serve as a good measure of equity assuming that future earnings are to remain the same as the present. However, the earnings that are relevant are future earnings rather than current or past earnings and would naturally affect a firm's stock that is priced in the market as a growth issue. Accordingly, a refinement of the earnings yield should be the substitution of expected future earnings for those currently reported.[23] Thus a modified price/earnings should be used as the measure of the cost of equity capital where expected earnings are those which would have been earned in the future by existing stockholders if the proposed financing was not made.[24]

In considering the cost of additional common stock, recognition should also be given to the fact that new issues can usually only be sold at some price below the current market less the costs of flotation. If a firm's stock is selling in the market at 50, the new stock may be offered by the underwriter at 48, less costs, or say 46 net to the company. In such a case the cost of equity capital should be based on net receipts rather than current market.

It is generally a difficult task in most cases to attempt to determine the price as well as the estimated future earnings of a common stock. Prices of stocks may vary widely, even for those with a broad market. In addition, while earnings of companies in stable industries may be estimated with some validity by basing judgments on the past, the task is highly difficult for companies of rapid growth or of those in cyclical industries.

The Cost of Retained Earnings

"A rapidly disappearing view holds that no cost is involved in the employment of reinvested earnings."[25] Such a mistaken view apparently seems to rest on the assumption that a corporation is separate from the common stockholders and that it costs the corporation nothing to withhold the earnings from them.[26] The importance of retained earnings is well known since it has been the most important source of capital financing for corporations in this country. Even though no payments are made for the use of retained earnings, their retention reduces the amount of dividends paid. This factor could depress the market price of a firm's stock and make any new issue more expensive. Accordingly, this additional cost of future stock financing may be the primary cost attributable to retained earnings.[27]

If it were not for the very real fact that income taxes as well as flotation costs must be considered, all earnings could be distributed as dividends and requirements for reinvestment could then be returned to the firm without additional cost by selling new stock to existing holders.[28] This assumes, of course, that stockholders would be willing to reinvest in the firm rather than some other investment. The point is that retained earnings do cost stockholders something since they could invest their dividends either back in stock of the firm or some alternative investment. Accordingly, the cost of retained earnings should be measured in terms of the opportunity cost to stockholders of retained earnings. In other words, assuming a price/earnings ratio of 10, management would not reinvest retained earnings in projects promising to yield less than this figure. Here we are assuming that the stock market is sophisticated enough that alternative investment prospects are on a par with one another, taking into account both earnings rate and risk, and the stockholders are saying they can earn up to, but not more than, 10 percent in alternative investments that have equal risk.[29]

Flotation costs as well as our tax structure favors the use of retained earnings over new issues of stock. As mentioned in the discussions of equity financing, the firm will generally always net funds from new stock flotations at a lessor figure than the market price. In addition, except for tax free institutions, net dividends to stockholders are reduced by income taxes.

The existence of taxes makes the calculation of the cost of retained earnings highly difficult unless only a few stockholders in the same income tax bracket exists. Spencer and Seigelman suggest that a workable solution for publicly held corporations might be to assume a medium tax bracket, or something above that based on the logical assumption that the lower-income groups in the economy do not own stock.[30] In the example, assuming a 30 percent tax bracket, a cutoff rate of 12 percent applied to projects to be financed by sale of stock would be equivalent to an 8.4 percent rate when retained earnings are used. In the absence of a perfect solution Solomon suggests that the minimum cost of retained earnings should be estimated earnings/price for tax-free holders.[31] Weston also suggests that retained earnings can best be regarded as another form of common stock investment and can appropriately be included in equity as an element of financing in calculating cost of capital.[32]

The Cost of Debt

Determining the cost of debt is generally more complicated than either new common stock or retained earnings since it often consists of both imputed as well as contractual costs.[33] Debt financing not only involves interest costs but also there is an additional cost to be measured since additional debt increases the risk to common stock holders and can make earnings more variable.

The usual measure of the effective percentage cost of debt has been the after tax interest rate paid to the bondholder taking into consideration the discount under or premium over par.[34] The yield to purchasers, when the obligation is held to maturity, and the cost to the company will be the same before tax, with adjustment, however, for the cost of issuing the debt.

The effective rate of interest can then be calculated by finding the rate of discount equal to the net proceeds and the sum of the present value of the debt repayments as they mature plus the present value of interest payments. Accordingly, it can be seen that the effective rate of interest can be arrived at using basically the same approach that is applied in discount rate of return on a capital expenditure proposal.[35]

As previously noted, interest on debt is a fixed amount and must generally be paid annually. With only equity in the capital structure, earnings per share will fluctuate with total earnings. However, with debt in the structure there may be wider savings in net earnings by "trading on the equity." The general principal here is that profits to stockholders will be increased if the rate paid on debt is less than the rate earned by the firm on that capital and, of course, just the opposite if the rate earned is lower.

It is generally well understood that when a firm obtains debt financing it exposes itself to risks which, once this debt approaches a large amount in relation to the total capital structure, increases in rapid fashion in comparison to the increase in debt itself.[36] Thus the cost of debt increases above its initial cost as more debt is used since generally the actual interest rate will rise and because of the additional risk and committing of a part of equity funds to back the financing, the price/earnings ratio of the stock may fall. Were it not for these factors, it would be difficult to imagine management ever financing by any other means than debt.[37]

It has been suggested that because of the interplay of forces between debt and equity that the true measure of all financing be taken to be the cost of equity funds.[38] The reasoning involved here is that management recognizes the hidden costs of borrowing and, given the firm's capital structure, will undertake new financing in the medium that is least costly so there will exist an equality between the real cost of debt and the cost of equity.

The Cost of Preferred Stock

The method used for determining the cost of preferred stock is similar in nature to that used for debt financing with, of course, some modifications. Some modifications are apparent since preferred stock has no maturity date as opposed to debt and also dividends are discretionary and thus not a fixed obligation. If preferred dividends are not declared and are not cumulative, the cost to the firm for that year may be omitted. However, it should be noted that such failure to pay the dividend is not costless since the credit of the firm may be adversly affected as well as having an affect on issues of securities to be financed in the future.[39]

Weighted Cost of Capital

Based on the foregoing comments, cost of capital may be expressed in a single composite figure which will reflect the cost of all funds to the firm. However, consideration should be given to the fact that there are many areas of disagreement in approaching cost of capital and the following observations by Lindsay and Sametz are shared by many authorities:

"...unfortunately far more influential is the practice of considering the cost of capital as a weighted average of all methods of financing that the firm has used, i.e., the firm's outstanding equity and debt at their current cost...this method assumes that the past methods of raising funds were and are ideal. That is, it assumes that the firm already has the optimum capital structure - the least-cost method of finance-and all it needs do is repeat its past pattern of finance foreover... The real issue of how to determine the least cost offunds or the ideal capital structure is not even explored by assuming that it is already known and is constant."[40]

Table VI sets forth some factors for consideration in calculating the cost of capital based on the present capital structure of a firm and Table VII reflects three methods that are used in obtaining weighted cost of capital after taxes (50 percent assumed rate) using net income after taxes as a base for common stock earnings and coupon rates or market yields for debt and preferred stock. As can be noted, three different answers are obtained and these are only a few of many methods used in arriving at a firm's cost of capital. Since cost of capital is considered as an opportunity cost in making decisions, it seems only logical that the third method used in Table VII is best for practical purposes. The past is history and cost of capital should be based on prices in the current market since this is more apt to be nearer the cost of acquiring any additional capital.[41]

The method suggested in Table VII is based on that used by Weston.[42] One major criticism of the calculation may be that present earnings on common stock are used rather than estimated earnings. As previously pointed, this can give misleading answers for growth firms as well as those subject to wide savings in earnings. Another suggestion for change might be the use of average market values over a period of time to adjust for fluctuations.

TABLE VI

FACTORS FOR CONSIDERATION IN CALCULATION OF COST OF CAPITAL

XYZ Company
Balance Sheet
12/31/65

Total Assets	$1,000,000
Current Liabilities	$ 200,000
Bonds - 4½%	200,000
Preferred Stock - 5½%	100,000
Common Stock - P/V $4	200,000
Surplus	300,000
Total Liabilities and Capital	$1,000,000

Income Statement
12/31/65

Earnings before Interest and Taxes	$ 120,000
Interest on Bonds	9,000
Net Profit before Taxes	$ 111,000
Taxes	55,500
Net Profit after Taxes	$ 55,500
Preferred Stock Dividends	5,500
Net Earnings for Common ($1.00 per share)	$ 50,000

MARKET VALUES OF CAPITAL

	Market Value	Yield
4½% Bonds	90	5%
5½% Preferred Stock	100	5.5%
Common Stock	16-2/3	E/P Ratio, 6%

TOTAL MARKET VALUE OF THE FIRM

Bonds	$200,000 x 90%	$ 180,000
Preferred Stock	$100,000 x 100%	100,000
Common Stock	50,000 shs x 16-2/3	833,000
		$1,113,000

Source: J. Fred Weston, Managerial Finance, Holt, Rinehart, and Winston, New York, 1962, p. 234

TABLE VII

CALCULATIONS OF COST OF CAPITAL

XYZ Company

1. Weighted Cost of Capital - Book Value Method

	Amount	After Tax Rate	Cost
Bonds	$200,000	2.25%	$ 4,500
Preferred Stock	100,000	5.50%	5,500
Common Stock	500,000	10.00%	50,000
	$800,000		$60,000

$60,000 divided by $800,000 = 7.5%

2. Weighted Cost of Capital - Book Value Method using Market Rates

	Amount	After Tax Rate	Cost
Bonds	$200,000	2.50%	$ 5,000
Preferred Stock	100,000	5.50%	5,500
Common Stock	500,000	6.00%	30,000
	$800,000		$40,500

$40,500 divided by $800,000 = 5.1%

3. Weighted Cost of Capital - Market Values Method

	Amount	After Tax Rate	Cost
Bonds	$180,000	2.50%	$ 4,500
Preferred Stock	100,000	5.50%	5,500
Common Stock	833,000	6.00%	50,000
	$1,113,000		$60,000

$60,000 divided by $1,113,000 = 5.4%

Source: J. Fred Weston, Managerial Finance, Holt, Rinehart, and Winston, New York, 1962, p. 235

There are numerous approaches to this calculation and many other changes could be made based on the opinions of various authorities on the subject. For example, Childs suggests using estimated common stock earnings over the next five years and Laurens recommends averaging both earnings and market prices over the past ten years as well as computing cost of capital on a pre-tax rather than after tax basis.[43] As noted earlier, dividends are sometimes used in place of earnings. To allow for both dividends and growth as a factor in market prices, Paul H. Seynes uses the dividend yield plus an average of the firm's growth rate in arriving at a rate for equity.[44]

Cost of Capital and the Capital Structure

It is generally accepted that cost of capital is not constant and that it is the function of the debt/equity ratio as well as other variables. Not only does the current capital structure of a firm affect new financing but the costs of future capital as well. The degree of financial risk plays an important role in the types of new financing as well as their costs and the real costs of different types of financing are frequently quite different from their apparent costs. If the interest payment on debt were the only factor to consider, one would possibly see more bond financing in the markets today and new equity financing would possibly decline to a nominal level. Realistically, continued inputs of debt should continue to bring the real costs up and increase risks to stockholders, ultimately bringing the costs of equity up.

In 1958 Frances Modigliani and Merton H. Miller presented a theorem relative to cost of capital and capital structure that has created a great deal of controversy among students of the subject.[45] Their proposition states that the average cost of capital to any firm in a given risk situation is completely independent of its capital structure and is equal to the capitalization rate of a pure equity stream of its class. They are, in effect, saying that a firm's cost of capital is free of leverage and does not change with changes in debt/equity ratios. This theory has gained little acceptance and the study by Barges in particular tends to disprove any merit of the proposition.[46]

Adjusting a firm's capital structure toward the optimum can lead to a reduction in cost of capital but a detailed discussion of the difficult task of attaining the optimum ratio is beyond the scope of this paper. Ideal ratios can vary greatly from industry to industry. As pointed out by Spencer and Siegelman, it becomes impossible to state objectively the debt/equity ratio that must be sought in striving for the point at which the marginal real cost of debt equals the marginal cost of equity.[47]

FOOTNOTES

CHAPTER V

1. Paul M. Van Arsdell, "Considerations Underlying Cost of Capital", Financial Analysts Journal, November - December, 1963, p. 69

2. S. L. Margoshes, "Cost of Capital - Guide to Mangerial Decision-Making", Financial Analysts Journal, July-August, 1963, p. 49

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10. "Financial Men Get New Angle", Business Week, May 20, 1961, p. 105

11. Ralph W. Laurens, "A Method of Determining What Money Costs Your Company", N.A.A. Bulletin, August, 1965, pp. 33-43

12. Lindsay and Sametz, Financial Management: An Analytical Approach, Richard D. Irwin, Inc., Homewood, Ill., 1963, p. 142

13. Robert W. Johnson, Financial Management, Allyn and Bacon, Inc., Boston, 1962, p. 207

14. S. L. Margoshes, op. cit., p. 50

15. Leonard Jay Santow, "Cost of Long-Term Capital from a Corporate Point of View", Financial Analysts Journal, May-June, 1963, p. 43

16. For a discussion of this point, see Ezra Solomon, "Measuring a Company's Cost of Capital", Journal of Business, October, 1955, pp. 240-52

17. J. Fred Weston, <u>Managerial Finance</u>, Holt, Rinehart, and Winston, New York, 1962, p. 231

18. Santow, <u>op. cit.</u>, p. 44

19. Ezra Solomon, <u>op. cit.</u>, p. 243

20. Robert W. Johnson, <u>op. cit.</u>, p. 212

21. S. L. Margoshes, <u>op. cit.</u>, p. 49

22. J. Fred Weston, <u>op. cit.</u>, p. 232

23. S. L. Margoshes, <u>op. cit.</u>, p. 49

24. See Ezra Solomon, <u>op. cit.</u>, for a discussion of accepting or rejecting proposals based on future earnings to stockholders

25. S. L. Margoshes, <u>op. cit.</u>, p. 51

26. Robert W. Johnson, <u>op. cit.</u>, p. 214

27. Leonard Jay Santow, <u>op. cit.</u>, p. 47

28. S. L. Margoshes, <u>op. cit.</u>, p. 51

29. Ezra Solomon, <u>op. cit.</u>, p. 246

30. Spencer and Siegelman, <u>op. cit.</u>, p. 406

31. Ezra Solomon, <u>op. cit.</u>, p. 247

32. J. Fred Weston, <u>op. cit.</u>, p. 233

33. Lindsay and Sametz, <u>op. cit.</u>, p. 148

34. S. L. Margoshes, <u>op. cit.</u>, p. 51

35. <u>Ibid</u>

36. Spencer and Siegelman, <u>op. cit.</u>, p. 407

37. Lindsay and Sametz, <u>op. cit.</u>, p. 132

38. Spencer and Siegelman, <u>op. cit.</u>, p. 407

39. Leonard Jay Santow, *op. cit.*, p. 44

40. Lindsay and Sametz, *op. cit.*, pp. 184-5

41. Robert W. Johnson, *op. cit.*, p. 215

42. J. Fred Weston, *op. cit.*, Chap. II

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Chapter VI

OTHER VALUATION CONSIDERATIONS

Minority Interests

An important consideration in any valuation case is whether the stock being valued represents a minority interest. Normally anything less than a controlling interest in a closely held company does not have a ready market and in many cases a stockholder can only sell at a financial loss.[1] Usually, the only prospective buyers of such stock are the majority holders.[2] In many cases the minority stockholders are unable to sell their interests on which they are receiving no return because majority stockholders, typically in charge of management, may use executive salaries rather than dividends in taking profits out of the business.[3]

Concerning minority interests, Revenue Ruling 59-60 states: "...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..."[4] The Courts also generally recognize that some discount is justified for a minority interest. In the Estate of Irene deGuebuant, the Tax Court concluded that the stock being a minority interest was sufficient grounds for holding that the fair market value was not equal to its asset value.[5] Similarly, in Betty Hanson, et al v. Commissioner, the court referred to Brooks v. Willcuts in noting that a minority interest in a family controlled close corporation has limited marketability.[6] Also, the court referred to Cravens v. Welch where the court said: "...and minority interests in a closed corporation are usually worth much less than the proportionate share of the assets to which they attach."[7]

Majority Interests

Revenue Ruling 59-60 states that control of a corporation, either actual or in effect, represents an added element of value and may justify a higher value for a specific block of stock.[8] It is, of course, apparent that a majority interest is worth more than minority shares since majority holders are in a position to control salaries, dividends, operating and other policies of the company.[9] In their discussion of minority and majority interests, O'Neal and Derwin make the following observations:

> "Suffice it is to say here, holders of a majority of the voting shares in a corporation, through their ability to elect and control a majority of the directors and to determine the outcome of shareholders' votes on other matters, have tremendous power to benefit themselves at the expense of minority shareholders."[10]

That potential purchasers of stock are generally willing to pay more for a controlling interest than for minority shares has apparently been given recognition by the courts. This point is borne out in a 1954 decision of Whittemore v. Fitzpatrick, a case which has an important bearing on the element of minority and majority stock.[11] In its decision the court determined that the per share value of stock with a voting control was $1,559. while the same stock without voting control was worth $1,057. per share.

Marketability

When appraising closely held stocks, marketability is a factor to be considered in arriving at a value. Stocks that are easily traded in the market are apt to command a premium over closely held stocks not having a market. All other things being equal, a marketable stock is more valuable than a stock lacking a ready market.[12] Accordingly, a discount for lack of marketability may be justified on the closely held stock -- particularly in cases where the comparative companies approach has been used in arriving at value. One method of determing the amount of discount required would be to determine the costs that would be required in creating a market for the stock.[13] Comparisons can be made with the under-writing costs incurred by various corporations in floating new issues of stock of various size in the market.

In recognizing the relevence of lack of marketability, the court in the Estate of Charles H. M. Atkins said that stock of a closely owned corporation would probably in normal circumstances sell at a lessor figure than comparable stock on an exchange and the value of underlying assets must be considered with this factor in mind.[14] Similarly, the Court of Claims in 1962 allowed a 12.17% discount for lack of marketability of the shares of the Heekins Can Company.[15] In arriving at this discount, the court took into account the testamony of three witnesses representing the Heekins family. Basing their estimates on "flotation costs" an investment banker used a 25% discount, a Certified Public Accountant used 15% and an officer of a firm specializing in the valuation of closely held stocks used 20%.

Sales of Stock

In contrast to market prices of actively traded securities, occasional sales of closely held securities may be insufficient to establish fair market values.[16] Concerning sales of closely held stocks Revenue Ruling 59-60 points out the following:

> "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."[17]

In the Heekins Can Company, the court, in arriving at a value of $15.00 per share, completely disregarded sales that took place within two years of the valuation date at $7.50 since the sales were between family members and friends.[18] The court observed that isolated sales of closely held stocks offer little guide to true value. In quoting from Robertson V. Routzohn, the court also said:

> "Fair market value presupposes not only hypothetical willing buyers and sellers, but buyers and sellers who are informed and have 'adequate knowledge of the material facts affecting the value'."[19]

Concerning isolated sales, the court in the Estate of F. M. Singe pointed out that in the absence of exceptional circumstances, the prices at which shares are traded in a free public market is the best evidence of fair market value.[20]

Blockage

Whether a large block of securities has a lesser value than a fewer number of shares because of the difficulity of selling it without depressing the market value has been the subject of much litigation and discussion and had been ignored by the Internal Revenue Service until the Regulations were issued under the 1954 Code.[21] The Regulations under Section 2031 of the code views the problem as follows:

> "...If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of values than market quotations..."[22]

It is now generally recognized that the sale of a large block of stock as a unit may depress the market and when there is adequate proof, the courts may conclude that quoted selling prices do not apply in such cases.[23] In the case of closely held stocks, however, the Internal Revenue Service in Revenue Ruling 59-60 takes the position that since no prevailing market prices are available, there is no basis for making an adjustment for blockage.[24] Some experts disagree with this conclusion and feel that a blockage discount is also warrented for closely held stocks.[25] Nevertheless, in the absence of official sanction, the appraiser may base his discount on "lack of marketability" using many of the same facts that justify a blockage discount for quoted securities.

Loss of Management

In many cases the decedent's death may have a material effect on the future of the business. Some experts consider the management factor to be one of the most important considerations in valuing a business concern.[26] Graham and Dodd point out that picking a company with good management is considered by many to be an even more important factor than picking a company that is in a prominent industry.[27] That this factor may materially effect a closely held corporation is pointed out in the following language of Revenue Ruling 59-60:

> "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 where 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."[28]

The capacity of management in relation to the performance of a company is difficult to evaluate, however, the factor has been given some weight by the courts in valuation decisions.[29] In valuing the stock of Olympic Commissary Company in the Estate of J. D. McDermott, the court concluded that the value of the stock had been adversely effected by the decedent's death since Olympic was basicly a "one-man" company.[30]

Summary

In this chapter emphasis has been placed on other major relevant factors that should be considered in implementing the methods used for valuing closely held stocks. Of the factors discussed, only the qualitative factor of loss of management may be considered as having a direct effect on the operations of the corporation itself. Minority and majority interests, marketability, sales of stock in the market, and blockage discounts do, nevertheless, merit the attention of the appraiser since their presence and absence in any valuation case can influence the price that may be finally determined as fair market value.

FOOTNOTES

CHAPTER VI

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6. Betty Hansen, et al v. Commissioner, P-H T.C.M. para. 52,236; Brooks v. Willcuts, 78 F 2d 270

7. Cravens v. Welch, 10 F 94

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27. Graham and Dodd, op. cit., p. 70

28. Revenue Ruling 59-60, op. cit.

29. Estate of P. M. Vandenhoeck v. Commissioner, 4 T.C. 125; Vernon Sharp, Jr. v. Commissioner, P-H T.C.M. para. 52,111; Estate of J. D. McDermott v. Commissioner, P-H T.C.M. para. 53,154

30. Estate of J.D. McDermott, op. cit.

Chapter VII

Conclusion

In an effort to obtain uniformity and consistency in valuation cases, various formulas have been advocated for determining the value of closely held stocks. One authority in the field has suggested a method which eliminates consideration of all the relevant factors normally examined in determining investment values and suggests that tax values be measured by assets, with some modification if earnings are extremely high in relation to book value.[1] Similarly, another suggestion has been made for the publication by the government of a single formula, with appropriate deviations to be considered in each case.[2] This thesis concludes, however, that valuation cannot be determined by a rigid formula nor any type of modified formula. No methods can be formulated to obtain uniform standards in valuation cases as each case must be considered on its own merits.

A realistic valuation must be based on all relevant factors and their aggregate significance should be weighed in each case. Nevertheless, the Internal Revenue Service appears to continue to use arbitrary formulas or rule-of-thumb estimates in arriving at values in many cases and taxpayers have also been guilty of using the same methods. Furthermore, the Tax Courts too often appear only to arrive at a mean value based on two extreme figures.[3] In addition, while it is impossible for the courts to adopt any uniform standards due to the nature of the valuation process, the author contends that the courts' failure to justify conclusions only increases the uncertainty of the outcome of valuation cases and increases the dilemma of the valuation process. The opinion that valuation decision-making is an uncertain process is also indicated by many owners of close corporations. In a recent survey of 401 firms that had either sold out or merged, 252 gave one of their reasons as being a desire to obtain more favorable treatment under estate and gift tax laws and 147 also pointed out their desire to obtain marketability of their stocks in order to avoid valuation uncertainties.[4]

While a compromise decision pleases neither side, it does have perhaps one advantage. It has been pointed out in an earlier chapter that one definition of fair market value is a figure at which the buyer thinks is too high and the seller thinks is too low. In many cases this is possibly what is reached in settling on a compromise figure.

Perhpas the numerous criticisms of the Internal Revenue Service for excessive valuations are overemphasized since valuation is a matter of judgment and taxpayers and authorities in the field are only looking at one side of the coin. It is a difficult problem for the taxpayers to approach a valuation case objectively since the figure arrived at will be the basis for payment of estate taxes. On the other hand, the Revenue Agent personally has nothing to gain monetarily by excessive valuations, since the Internal Revenue Service, particularly in recent years, has emphasized that the merit ratings of agents is not based on the amount of taxes collected but rather on their fairness in settling each case. In many instances, it is probable that agents use methods to produce high valuations only because taxpayers are guilty of submitting unrealisticly low values. It may be concluded, therefore, that these high figures are used only for "horse-trading" purposes.

In theory the fiduciary is striving to obtain "fair market value" in valuation cases, while in practice it is the duty of the fiduciary to achieve an acceptable value that will result in a minimum of tax liability to the estate within the limits that are provided by law. Accordingly, we are not in reality using an intelligent approach to security analysis but rather attempting to justify the lowest possible value. On the other side, the author feels that in most cases revenue agents are just as unrealistic and perhaps less sophisticated in their approach. Aside from the high figures for "horse-trading" purposes, it seems the agents in general fail to use an intelligent approach to valuation simply for lack of experience and training in security analysis. Most estate tax agents are trained in the legal aspects of estate taxes and on-the-job training in valuation of securities is limited since, on a percentage basis, closely held stocks are involved in very few estate tax returns. It is felt, therefore, that at least several agents at the office of each District Director of Internal Revenue should receive specialized training in the field of security analysis and be assigned to handle all cases involving closely held stocks.

It has been the author's experience in audit valuation conferences with revenue agents that when the taxpayer uses soundly conceived and effectively presented techniques in an attempt to arrive at a realistic value, he will receive fair treatment in most cases. This conclusion is further borne out by the survey conducted by the Harvard Graduate School of Business Administration.[5] Nevertheless, the author maintains that the taxpayer is at an unfair disadvantage since the tax authorities' valuation is considered correct unless convincing evidence can be produced to overcome this presumption. In the Tax Court the burden of proof is on the taxpayer and many injustices result from the difficult task of proving the Commissioner's valuation erroneous. In addition, on numerous occasions the taxpayer yields to the Commissioner's valuation simply to avoid litigation costs because of this disadvantage. The author concludes, therefore, that one corrective measure to insure more equitable valuation decisions would be to put the taxpayer on equal terms with the Commissioner by eliminating from the law the presumption that the Commissioner's valuation is *prima facie* correct.

It has been argued that "expert opinion" is a valuable tool in obtaining fairness in the courts and much weight has been given to this factor in many court decisions.[6] This does not appear to be the ultimate solution, however, since there is a substantial judgment factor involved in each case and it is only natural that both the Internal Revenue Service and the taxpayer would present experts that were more in favor of their own point of view. Since the courts base their decisions on the evidence presented by both sides, it would appear that there would only be a continuation of compromise decisions. Since valuation cases make up only a small part of the Tax Court dockets, it is difficult for judges to become specialized in this field. A more practical solution to the problem - and this is a major conclusion of the thesis herein presented - would be for the court, in the absence of agreement by both parties in a dispute, to retain an independent appraisal company to value the stock and base their decision on their appraisal. There are many firms that specialize in the valuation of closely held securities and some may contend that their approach will also be a matter of judgment; nevertheless, such an objective valuation by experienced experts should result in a more equitable value for both the Internal Revenue Service and the taxpayer.

The observation was made earlier in this chapter that the conclusion of this thesis was that valuation cannot be determined by rigid formulas and no methods can be formulated to obtain uniform standards in valuation cases. Nevertheless, recognition should be given to the possibility that a specific tax formula could not only eliminate the uncertainties in valuation cases but also simplify the administration of the estate tax law as well as reducing the cost of preparing valuations and preventing prolonged delays and litigations for both the taxpayer and the government. The methods advocated by Ralph C. Rice and Edwin C. Borreli are two of a large number of recommendations made in the past for a specific formula.[7] Another method that has gained wide recognition, and which in the opinion of the author has some merit, suggests a valuation based on a statistical study of price relationships of the stocks listed on the New York Stock Exchange.[8] As a basis for their study the writers used a correlation analysis between prices, earnings, dividends and book values of 180 stocks for selected years. While a formula based on such a study could only be approximately accurate as applied to any one closely held stock, such a method would, in all probability, provide on the average approximately the same amount of revenue for the government and at the same time reduce the uncertainty, as well as other problems, that now exist in valuation cases.

FOOTNOTES

Chapter VII

1. Ralph C. Rice, "The Valuation of Closely Held Stock: A Lottery in Federal Taxation", University of Pennsylvania Law Review, February, 1950, p. 367

2. Edwin C. Borreli, "Valuation of Closely Held Securities for Estate and Gift Tax Purposes", The Tax Counselor's Quarterly, June, 1962, p. 145

3. See Chelcie E. Bosland, "Tax Valuation by Compromise", Tax Law Review, April, 1964, pp 77-89. In a study of 133 valuation decisions, Professor Bosland concludes that to a great extent valuation is a "horse-trading" affair and there is a tendency for the Tax Courts to reach a compromise decision.

4. Chelcie C. Bosland, "Has Estate Taxation Induced Recent Mergers?", National Tax Journal, June, 1963, p. 159

5. J. K. Butters, "Recent Trends in Industrial Concentration and Taxation", Taxation and Business Concentration, Princeton Tax Institute, 1952, p. 15

6. See Estate of Barbara F. Thompson v. Commissioner, P-H T.C.M. para. 59,183; Estate of Morris Braverman v. Commissioner, P-H T.C.M. para. 62,085

7. Ralph C. Rice, op. cit; Edwin C. Borreli, op. cit.

8. L. R. Johnson, Eli Shapiro and Joseph O' Meara, Jr., "Valuation of Closely-Held Stocks for Federal Tax Purposes: Approach to the Objective Method", University of Pennsylvania Law Review, November, 1951, p. 166

APPENDIX A

CHECKLIST FOR VALUATION OF A CLOSELY HELD BUSINESS

(I) Complete history of company

- (A) Date incorporated
- (B) Capitalization
- (C) Type of business
- (D) Any changes in operation of business

(II) Stock holdings

- (A) Closely held as opposed to many investors
- (B) Is stock to be valued majority or minority interest

(III) Type of stock

- (A) Amounts of common and preferred: (1) When issued; (2) Issued price; (3) Proximity of issue date to valuation date.
- (B) Restrictions on sale, if any.

(IV) Sales of stock

Actual sales - before and after valuation date
- (1) Number of transactions
- (2) Circumstances of sales: (a) Whether or not arm's length transaction; (b) Amount of advertising and effort required for sale; (c) Amount of commission paid to salesmen who obtain buyers.

(V) Financial data of company

- (A) Balance Sheet at date of valuation
  - (1) Per books
  - (2) Adjusted to fair market value of assets
    - (a) Need of proper reserves against receivables
    - (b) Condition of inventory to see whether it is: (1) Obsolete; (2) No longer in demand.
    - (c) Condition of fixed plant to see whether it is: (1) Modern; (2) Needs to be replaced; (3) Needs major repairs.
    - (d) Unrecorded liabilities: (1) Possible tax deficiencies; (2) Law suits.
    - (e) Errors in books overstating or understating assets and liabilities.
  - (3) Adjusted to fair market value of assets less expenses of liquidation and losses due to liquidation.
- (B) Data for at least 10-year period of
  - (1) Gross sales
  - (2) Net income: (a) Per books; (b) Per tax return; (c) Adjusted for abnormal items and errors.
  - (3) Capital and surplus
  - (4) Dividends
  - (5) Current ratio
  - (6) Per cent of investment in fixed assets to total assets

(7) Ratio of earnings to dividends
(8) Per cent of net income to sales
(9) Average of items 1 through 8 for a 3-year, 6-year and 10-year period
(10) Items 1 through 8 for a few years after valuation date to help support evidence as to prospects of company at that time.

(VI) Management of Company

(A) Continuity
(B) Reliance on any particular individual
(1) What happened to firm on his death: (a) Did earnings go up or down? (b) How long did it take to get running efficiently again? (c) Were policies changed with regard to dividends?

(VII) Peculiarities of industry

(A) Competition: (1) Price wars; (2) Unfair labor practices of competitors; (3) Pirating; infringements of patents, copyrights, trademarks or secret processes; (4) Secret rebates.
(B) Trend of industry: (1) Prospects at valuation date; (2) Possible cyclical nature of industry.
(C) Certainty or uncertainty of operating conditions:
(1) Fluctuations in price of raw materials
(2) Fluctuations in price of products sold
(3) Length of production cycle
(4) Inventory risk
(5) Availability and cost of labor
(6) Certainty of sales market: (a) Dependence upon unpredictable public taste; (b) Influence of occasional best sellers, styles, etc.; (c) Dependence on public "crazes" and "crushes" that are unpredictable; (d) Variations of sales price by foreign dumping, etc.; (e) Dependence of sales volume on stimulus of the occasional new discovery, invention, innovation, etc. in production, sale or distribution; (f) Dependence on seasons for sale of seasonal items.
(7) Pressure groups: (a) Consumer leagues' pressure; (b) Sanctions by religious groups; (c) Dictation from ethnic groups; (d) Temperance groups; (e) Organized labor pressues; boycott; (f) Picketing; (g) Gangster coercion.
(8) Governmental restrictions: (a) Tariffs; (b) Price controls; (c) Unequal tax burdens; (d) Health laws, quarantines, police and fire laws, injunctions or foreclosures.

(VIII) Special circumstances at valuation date of business in question

(A) Heavy purchase commitments
(B) Strikes
(C) Deficiencies in product causing future loss of customers and/or heavy costs to meet complaints and returns
(D) Change in supply of materials in quality or quantity which might cause severe deterioration in quality of product with consequent loss of market

(E) Personnel difficulties such as: (1) Illness of important persons;

(2) Inability to get employees; (3) Accidents; (4) Occupational diseases.

(F) Location problems caused by: (1) Movement of customers to other areas; (2) Changes in sources of supply.

(G) Internal difficulties: (1) Dissension and quarreling among management; (2) Theft and embezzlement; (3) Crippling or unusual litigation; (4) Excessive waste and spoilage; (5) Revolutionary changes in price and managerial policy; (6) Incompetent, inexperienced or neglectful personnel; (7) Failure to maintain properties; (8) Failure to maintain research and proper market analyses; (9) Bad credit policies; (10) Investment in undesirable or uneconomic property; (11) Improper financing, inefficient budgeting; (12) Inefficient sales organization.

(H) Local conditions: (1) Local prosperity; (2) Marriage, birth and death rates; (3) Migrations; (4) Immigration.

(I) "All eggs in one basket": (1) Single or small group of suppliers; (2) Chemist or key individuals who control process of production; (3) Single sales outlet.

(J) Legal difficulties and obligations: (1) Restrictions against sale in certain areas; (2) Restrictions against sale of certain articles; (3) Restrictions imposed by union contracts; (4) Restrictions imposed by contracts with competitors; (5) Long-term leases based on sales or purchase contracts at high prices; (6) Long-term sales contracts at too low a price.

(IX) Data for comparative companies

(A) Proof of comparability: (1) Per cent of net income to sales; (2) Current ratios; (3) Per cent of investment in fixed assets to total assets.

(B) Price - earnings ratios using 3, 6 and 10 year averages

(C) Dividend yield using 3, 6, and 10 year averages

(D) Ratio of price to book value per share using 3, 6 and 10 year averages

(E) Computations using Items (B), (C) and (D) on date for stock in question

(X) Prior appraisals

(A) Inheritance tax

(B) Gift tax

Source: Estate Plans, Institute for Business Planning, Inc., New York

APPENDIX B

Buy-Sell Agreement - Close Corporation

Agreement entered into this 4th day of September, 1958, by and between John White, hereinafter referred to as "WHITE", and JOHN GRAY, hereinafter referred to as "GRAY".

WITNESSETH:

The present holdings of stock of White and Gray in the John White Corporation, a domestic corporation having its principal place of business at Springfield, Ohio, hereinafter referred to as "CORPORATION", are as follows:

John White	100 shares
John Gray	100 shares

The said shares constitute all the shares of the Corporation issued and outstanding.

White has applied to the Zenith Insurance Company and the company has issued Insurance Policy No. 1 on the life of Gray in the sum of $50,000, payable upon Gray's death to White, and White has paid the first premium thereon.

Gray has applied to the Zenith Insurance Company and the company has issued Insurance Policy No. 2 on the life of White in the sum of $50,000 payable upon White's death to Gray, and Gray has paid the first premium thereon.

Therefore, in consideration of the Premises and the Mutual Promises herein Contained, the Parties agree:

Article I: The parties have deposited their respective stock certificates, duly endorsed for transfer, and the aforesaid life insurance policies in a safe deposit box at the Worthy Trust Company, Springfield, Zenith, in which access shall be jointly or by the executor of either party's estate. Neither party shall have the right to remove the stock certificates or policies during their joint lives.

Article II: During their joint lives, the corporation shall pay any and all premiums as they fall due on the said policies and charge the account of each party to the extent of the premiums on said policy.

Article III: Upon the death of one of the parties, the survivor will purchase from the executor of the stockholder first to die, all of said shares in the corporation for the sum of $50,000. The assignment of the above mentioned life insurance policy upon maturity will be accepted by the executor as payment in full.

Article IV: Closing shall be held within two weeks after Letters Testamentary or Letters of Administration shall have been issued to the legal representatives of the estate of the party first to die and shall be held in the office of the Worthy Trust Company, at which time the surviving party and said executor will execute any and all documents necessary or expedient to effectuate the assignment of such policy.

Article V: Upon the death of the party first to die, the survivor may acquire the life insurance policy held by the deceased on his life according to the terms of this agreement, for the cash surrender value and if there be no cash surrender value, then for one half the amount of the premiums paid on said policy.

Article VI: The individual owners and holders of the stock of the Corporation shall retain all rights of an owner except those specifically renounced by this agreement.

Article VII: Neither of the parties shall pledge, assign or otherwise encumber, transfer or present to be transferred said stock and insurance policies by any means whatsoever except as herein set forth.

Article VIII: This agreement shall be of no effect:

(1) If a certificate of dissolution of the Corporation, or a petition in bank-

ruptcy or a petition for the appointment of a receiver has been filed before the death of the party first to die.

(2) If the corporation ceases to do business before the death of the party first to die.

(3) If the insurance policy of the deceased for any reason shall not be in full force and effect for its face amount.

(4) If both parties die prior to the transfer of said stock.

Article IX: This agreement shall be binding upon all the parties hereto, their heirs and legal representatives, and the executor shall execute all documents necessary to effectuate the terms of this agreement.

IN WITNESS WHEREOF, the parties have signed and sealed this agreement.

______________________________ L.S.
John White

______________________________ L.S.
John Gray

Source: Tax Tested Estate Planning Forms, Institute for Business Planning, Inc., New York

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