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Capital-stock Valuation in Tax Cases

BY O. K. BURRELL

Courts are called upon to make decisions involving proper methods of capital-stock valuation in estate cases and cases involving the determination of taxable net income. In income-tax cases the valuation under review is usually that of March 1, 1913. It is impossible, for constitutional reasons, to tax income accrued prior to the date at which the income-tax amendment went into effect—March 1, 1913. The taxable profit upon the sale of stock after March 1, 1913, which was acquired before March 1, 1913, is the difference between the selling price of the stock and its cost, or the difference between its selling price and its March 1, 1913, value, whichever is lower. The taxpayer is thus interested in establishing as high a March 1, 1913, value as possible. In estate and inheritance-tax cases the taxpayer desires as low a valuation as possible, for the reason that the tax is levied upon the value of the estate, or upon the value of the inheritance, depending upon the jurisdiction. In both income-tax and estate cases involving capital-stock valuation the courts usually do not affirmatively fix a value upon capital stock, but undertake only to review the fairness and legality of methods applied by the proper officers.

Obviously it is a very difficult matter to lay down a general rule or method of capital-stock valuation which can be consistently applied in all cases. The factors that make values are so intangible and elusive that it is difficult to reduce them to a mathematical formula. The value of any asset, including capital stock, may be thought of as the anticipated future returns from the asset discounted back to the present at a discount rate which is largely contingent upon the certainty of the future benefit. The so-called "pure interest rate," or the rate which is paid for riskless capital, is also a factor. In a business sense, there is no motive for the ownership of capital assets other than the desire for future returns. The present value of the future income is intimately related to the certainty of realization of the income. If the future benefit in the way of income is reasonably certain, the discount rate used to compute present value may be low. If the future benefit is uncertain of realization, a very high rate of discount must be applied to estimate present value. It should be borne in mind that the higher the rate of discount applied to future income, the lower is the present value. Two things are necessary, then, in order to establish the value of an asset:

(1) An estimate of the future benefits to be obtained from the asset.
(2) Some idea of the rate of discount by which these future values may be translated into present value.

This concept of valuation as discounted future income or benefit essentially coincides with the legal concept of fair market value. Courts are much inclined to accept evidences of actual sales as the basis of valuation when possible, but the price paid by the buyer may be presumed to be determined in large part by his estimate of future income. When no sale prices are available courts have used methods of valuation for capital stock which are in effect the discounting of future income. The determination of the rate of discount to be used and of the amount of future income expected is difficult. In the case of listed securities there is in published quotations some official record of the investing public's estimate of these intangible value factors. There is, however, the possibility that even the published quotation of a stock may not be an indication of its fair market value at that time. The price quoted may be a result of manipulation, or it may represent the sale of a number of shares much smaller than the block of stock being valued. The block of stock under valuation may represent control of the corporation, which sometimes is valuable quite apart from any question of the stock's intrinsic value. An offer of a large number of shares for sale may be expected to depress the price. The valuation of unlisted stock which is closely held is a much more difficult matter. Here the court must pass upon methods used in determining the price that a willing buyer would be willing to pay, or a willing seller to accept, in view of the special circumstances. These special circumstances include "the earning power of the corporation, the quality of management, the prospects for future earnings, the proportion of earnings disbursed as dividends," etc. Notwithstanding the difficulties involved, these intangible factors of value must be reduced to a definite method of valuation and that method must be applied to the particular situation.

When stocks are listed upon a stock exchange and quotations of actual sales are available, or when there is evidence of bona-fide sales in the case of unlisted stocks, courts are almost universally inclined to accept these sales figures as a proper valuation.* This is true even though such sales were made in quantities much smaller than the block of stock under valuation (*Commonwealth* v. *Bingham's Administrator*, 196 Ky. 318).

The acceptance of actual sale figures as a basis of valuation seems entirely proper. The best evidence of the price a willing buyer would be willing to pay, or a willing seller to accept, is obviously the price that willing buyers and willing sellers actually arrive at in the market. This is the rule adopted by statute in New York. When quotations on a stock exchange are a result of "forced sales," however, they do not constitute a proper basis of valuation (*Walter* v. *Duffy*, 287 Fed. 41).

When the stock under valuation is inactive or closely held the method is not so obvious. There seem to be two quantitative approaches to valuation in this situation. The first is the book value of the stock based upon an appraisal of the assets. This appraisal of assets may include a revaluation of existing tangible assets and also an estimate for goodwill, whether or not goodwill is entered on the books of the corporation. The second is that of capitalization of earnings at a rate assumed to compensate for the intangible factors present. As a matter of fact the two methods are based upon the same thing, since earning power usually forms the basis for the estimate of goodwill. Courts have quite generally recognized that earning power is the foundation upon which valuation is based and that other considerations are important only as they have a bearing on present or future earning power.

* See the following cases: *Walker* v. *People*, 192 Ill. 106; 61 N. E. 489; *In re Smith*, 76 N. Y. S. 185; *Matter of Gould*, 19 App. Div. 352; 156 N. Y. 423; *Matter of Chamber*, 155 Supp. 153; *People* v. *Coleman*, 107 N. Y. 541; 14 N. E. 431; *Matter of Kennedy*, 155 Supp. 192; *Matter of Cook*, 50 Misc. (N. Y.) 487; *Rice* v. *Eisner*, 16 Fed. (2d series) 358; 6 Am. Fed. Tax Rep. 6058, T. D. 3974.

This may not be entirely true in the case of the "cash asset" stocks. The book value of the capital stock of a corporation whose assets consist largely or entirely of cash, or assets which can be quickly turned into cash, represents the amount of a possible liquidating cash dividend. The valuation of the capital stock of a corporation of this type could not logically be less than liquidating value. The valuation figure could, of course, be greater than liquidating value if it appeared that the present or prospective earnings and dividends of the corporation were large enough to constitute a reasonable rate of return on the higher valuation. As a matter of fact, the current market prices of the leading bank and trust-company shares reflect valuations several times as large as the liquidating value of the stock of these companies. The deciding factor in establishing the valuation of cash-asset stocks above book value must come back inevitably to present or prospective earning power.

In the case of the ordinary industrial corporation, the appraisal of assets (except cash and cash assets) is directly related to their present or future capacity to produce an income. In a sense, then, it may be said that the valuation of capital stock from the book value based upon appraisal of the assets is in essence valuation based upon anticipated earnings. This is particularly true in case the appraisal of the assets includes an appraisal of goodwill. Thus the court said *In re estate of Dupignac* (204 N. Y. S. 273):

> "The method of valuation adopted by the courts is to 'ascertain the cash value of the property which the shares represent, assigning to each share its proportionate worth.' The book value of stock is its intrinsic value. If there had been no sales, the assessor must necessarily fall back upon the book value as the nearest approximation to the fair market value. In the absence of sales the book value must be taken as the basis of computation. . . . In arriving at the number or multiple to be used to multiply the average net annual profits to ascertain the value of the goodwill, I have taken into consideration the yearly earnings and the earning power; . . . the business sales; the increased assets; the corporate existence of 36 years; . . . In the instant case, in view of all the facts, I have taken five years' purchase as the factor as not unreasonable nor excessive and being suitable and proper, having reference to the nature and character of the particular business under consideration."

It is evident that the court did not use the term "book value" in the usually accepted business sense. Certainly few if any business men will agree that "the book value of stock is its intrinsic value." Clearly, the actual valuation was in large part dependent upon earning power of the corporation because of the fact that earning power was taken as the basis for determining the cash value of the goodwill.

In *Boyd* v. *Heiner* (5 Am. Fed. Tax Rep. 6069) the valuation of stock was established through appraisal of the assets including goodwill. In this case, however, the estimate for goodwill was reached in a slightly different way. The average of six years' earnings was first computed. From this average annual-earnings figure was deducted an amount equal to 8 per cent. of the conceded value of the tangible assets on March 1, 1913. The remainder of the earnings were considered as attributable to goodwill and capitalized at 15 per cent. in order to determine a value for goodwill. The estimated goodwill was then added to the conceded value of the tangible assets and the total was taken as the value of the company as a going concern.*

The unsuccessful attempt of the treasury department to assess additional income taxes upon the minority stockholders of the Ford Motor Company who sold their stock in 1919 illustrates very well the difficulties involved in the valuation of capital stock which is closely held. In brief the facts were as follows: In 1919 certain minority stockholders in the Ford Motor Company were asked to sell their stock to Henry Ford and Edsel B. Ford. These minority stockholders had acquired their stock prior to March 1, 1913, and it was stipulated that the cost was lower than the March 1, 1913, valuation. The taxable profit upon the sale would have been, then, the difference between the sale price and the March 1, 1913, valuation. For the individuals in question the income tax would have amounted to about two thirds of whatever taxable profit was realized. (The 1918 act did not provide for the taxation of capital net gain at 12½ per cent.) Hence, the question whether or not the offer should be accepted depended upon the March 1, 1913, valuation. In this situation the buyers of the stock applied to Daniel C. Roper, then commissioner of internal revenue, and requested official inquiry and action fixing the 1913 valuation for the guidance of those who were asked to sell. Accordingly the commissioner fixed a figure of $9,489.34 per share as the fair 1913 value. The stock was then sold (at prices ranging from $12,500 per share to $13,444 per share) and the sellers included in their 1919 returns the difference between the sale price and $9,489.34 per share as the taxable profit on the sale. On March 1, 1925, Commissioner Blair levied a further deficiency assessment upon the profit from the Ford stock sale upon the

* See the following cases: *Matter of Valentine*, 163 N. Y. App. Div. 843; 147 Supp. 1146; *Matter of Bach*, 147 N. Y. S. 289; *Matter of Jones*, 172 N. Y. 575; 65 N. E. 570; *Matter of Laidlaw*, 176 N. Y. S. 885.

theory that the fair value of the stock on March 1, 1913, had been $2,634 per share, thus indicating an additional profit of $6,855.34 per share. The only justification for the additional assessment, according to counsel for the government, was that it represented a "new and better view of the same facts" based upon a "matured and better judgment." This 1925 deficiency assessment was paid, and one of the former minority stockholders, Mrs. Alice G. Kales, brought suit to recover and was successful. The case was appealed to the United States circuit court of appeals by the government, and here the decision of the lower court was affirmed (*Woodworth* v. *Kales*, 26 Fed. Rep. [2d series] 178). Another of the former minority stockholders, James Couzens, United States senator from Michigan, took his case before the board of tax appeals. This body decided that the government had the right to reopen the question of the March 1, 1913, value of the stock, but that the commissioner was in error in his revision of the valuation. The board decided that the fair value of the capital stock of the Ford Motor Company, on March 1, 1913, was $10,000 per share. This was in effect a victory for Mr. Couzens (*James Couzens* v. *Commissioner*, 11 B. T. A. 1040). The government recently announced that neither the case of Mrs. Kales nor the case of Mr. Couzens would be appealed further. In both cases the main issue was the fair value, on March 1, 1913, of the capital stock of the Ford Motor Company.

The available facts upon which the valuation was based were concerned with the earnings of the Ford Motor Company in the years prior to 1913, and the future growth of the concern that was "reasonably in prospect" on March 1, 1913. The board recognized that the intangible factors in the situation were important only as they related to earnings. The board said:

> "Primarily the earnings are the test of success of the past and the indication of the future. The other statistics . . . of production, sales, etc., and the description of the management and its methods and plans serve to give depth and perspective to the earnings. . . . They are significant not of their own weight or force but only in their relation to earnings."

The net earnings of the Ford Motor Company, adjusted to calendar years prior to 1913, were:

1906	$ 175,615.24
1907	1,001,767.44
1908	1,168,953.55
1909	3,176,007.18
1910	4,145,901.74
1911	7,541,493.01
1912	14,119,989.87

January, 1913, produced net earnings of $2,249,685.70, the largest of any month in the company's history, over five times as large as earnings in the preceding January, of 1912, and almost ten times those of January, 1911. February, 1913, with $1,723,210.47, was three times as profitable a month as February, 1912, and over four times as profitable as February, 1911. The experience of the company indicated that the earnings of every year had been more than eight times the earnings of January and February combined; so if this experience were to be taken as giving a normal ratio, the entire year 1913 would presumably have yielded over $30,000,000.

The price of the Ford car had been reduced. New construction was about to begin and "plans were afoot for producing 200,000 cars in the year 1913, instead of 75,000 which had been planned for 1912, 80,975 which had been manufactured in that year, and 78,611 which had been sold."

The method of valuation applied by Commissioner Roper in 1919 was to add the profits of January and February, 1913, and multiply by 6, thus getting an estimate of the profits for the entire year. The January and February, 1913, profit figures indicated a profit for 1913 of $23,837,377.02. This estimated 1913 profit was then averaged with the actual 1912 results. The average for the two years amounted to $18,978,683.44, and this was capitalized at 10 per cent., giving a total valuation for the Ford Motor Company of $189,786,834.40. This figure was divided by 20,000, the number of shares then outstanding, which gave $9,489.34 as the March 1, 1913, value, as set by Commissioner Roper.

It would seem to the disinterested student of capital-stock valuation that Commissioner Roper's 1919 estimate was amply conservative. The commissioner estimated the 1913 earnings of the company by multiplying the January and February, 1913, earnings by 6, when the experience of the company clearly indicated that the January and February earnings were normally only one eighth of the year's total. He capitalized at 10 per cent. the average of the 1912 and 1913 earnings without giving any weight to expected future growth in earnings. It is true that a great deal of the argument in the cases centered around the question of how much of the growth of the Ford Motor Company after 1913 was reasonably in prospect on March 1, 1913. It was necessary that the March 1, 1913, valuation be established in the light of the facts, opinions and prejudices which existed at that time, and not in the light of developments that had taken place since that date. It should be remembered that the year 1912 marked the culmination of the "trust busting" era. On March 1, 1913, there had been a change in political control in the United States and a special session of congress had been announced. Tariff reductions were in prospect. The financial world feared radical legislation. War clouds were gathering in Europe. There was revolution in Mexico. These are all facts which have a bearing on the price that a willing buyer would have paid a willing seller for stock in the Ford Motor Company on March 1, 1913. It must also be remembered that on March 1, 1913, common stocks had not attained their present popularity as instruments of long-term investment. It seems evident, however, that considerable growth of the Ford Company was indicated from the known facts. That there had been a tremendous growth in earnings from 1906 to 1912, that the price of the car had been reduced, that orders were pouring in at an unprecedented rate, and that economies in production had been effected were established facts on March 1, 1913. In view of the unquestioned dynamic factors in this situation, it appears that Commissioner Roper's valuation was amply conservative.

The treasury department, however, sought on March 13, 1925, to assess additional taxes upon the theory that the fair value, on March 1, 1913, had been only $2,634 per share. The method used by the treasury department in this valuation was predicated on the theory that the average annual income, $43,500,000, for three years prior to the sale (1919) was to the total value at the time of the sale, $266,400,000, as the average annual income in the three years prior to 1913, $8,602,000, was to the fair market value of the total stock as of March 1, 1913. This developed a total value, as of March 1, 1913, of $52,680,000 for the 20,000 shares outstanding, or a value of $2,634 per share. This valuation, had it been upheld, would have resulted in a materially higher tax. It seems obvious that this three-years'-average-earnings figure was absolutely without significance. Consider that earnings had increased more than 300 per cent. during this short period, and that another large increase for 1913 was indicated by the January and February results. Was there any reason to suppose that this three-year average represented the profit-earning ability of the Ford Motor Company in the years following 1913?

Later the department relied upon still another method. By this method the average annual earnings for the approximate three-year period ending March 1, 1913, were found. From this figure was deducted an amount equal to 8 per cent. of the conceded value of the tangible assets. The remainder was considered as the earnings attributable to intangibles and was capitalized at 15 per cent. This resulted in a valuation for intangibles of $48,438,235.67. This was added to the conceded value of the tangible assets, $22,518,635.02, and the result was a valuation for the 20,000 shares outstanding on March 1, 1913, of $70,956,870.69, or a value of $3,547.84 per share.

The attitude of the court and the board of tax appeals toward the formula-inventing activities of the department seems sound. The court held in the Kales case that the commissioner had no authority to change the March 1, 1913, valuation fixed by his predecessor in office unless there was evidence of fraud or mistake as to the facts upon which the valuation was based. No fraud or error as to facts was claimed by the department. The board of tax appeals held in the Couzens case that the commissioner had the authority to reopen the question of March 1, 1913, value, but that the commissioner was wrong in his revised valuation and that the fair market value of the stock of the Ford Motor Company on March 1, 1913, was $10,000 per share. The valuation fixed by the board, it will be noted, is very close to the $9,489.34 valuation fixed by commissioner in 1919. After reviewing the earning capacity of the Ford Company and its prospects for future growth as they appeared on March 1, 1913, the board very sensibly said:

> "We are of the opinion that the fair market price of the stock owned by this petitioner in the Ford Motor Company on March 1, 1913, was at the rate of $10,000 per share. While we have not arrived at this value by the application of any mathematical formula, because we believe there is no authoritative formula available, we have given careful consideration to the several methods suggested in the course of the trial and have not been unmindful of the aid to be derived from the use of such tests."

American courts are traditionally reluctant to set up their judgment of capital-stock value as superior to the judgment of a purchaser in good faith. In case no sales are available as a guide to value, however, the primary factor given consideration is that of future earning power.