What Revenue Ruling 59-60 Says (and Does Not Say) About

FAIR MARKET VALUE

Analysis and Review of This Seminal Ruling from Business and Valuation Perspectives

By: Z. Christopher Mercer, FASA, CFA, ABAR

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Table of Contents

Author's Introduction

Revenue Ruling 59-60 defines the concept of fair market value for the purpose of appraising businesses and business ownership interests for gift and estate tax purposes. This famous ruling of the Internal Revenue Service (IRS) is at one and the same time the most often quoted ruling or statute applicable to the valuation of businesses, and also the least understood. The language of RR 59-60 is often quoted by appraisers, lawyers, and judges. Unfortunately, it is often quoted out of context and even misquoted.

The basic guidance of Revenue Ruling 59-60 is as sound in the early 2020s as it was when issued as the sixtieth ruling for the year of 1959. As we will see, the major flaws with the ruling are flaws of omission or emphasis. What is in the ruling is, for the most part, quite sound.

Most business appraisers admit, when asked, to having read the ruling – a long time ago. Many tax advisors admit to the same sort of reading at some time in the past. Nevertheless, RR 59-60 is a living document, and we will bring its content and guidance into current perspective.

What is not in the ruling may be surprising to many readers. The table below shown the results of a search of the document for some commonly used valuation terms.

Term	Frequency	Context of Use of Terms
Minority	1	"...a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock..."
Minority Discount	0	
Liquidity	0	
Marketability	0	
Marketability Discount	0	
Control Premium	0	
Control / Controlling	6	"...individual or group in control can..." *inpact salaries, dividends, etc.* Dividends are "...discretionaly with controlling shareholders." Forced or isolated sales do not "necessarily control as the measure of value." Control of a corporation represents "an added element of value" and "may justify a higher value for a specific block of stock."
Dividends	14	The focus of the discussion of dividends is on the capacity to pay them. The drafters were suspiscious of actual dividends because they could be influenced by controlling owners. There is a warning against using a capitalization of dividends as a valuation method

There is no mention of minority interest or marketability discounts in the ruling. In fairness, these terms were in development in the years following the issuance of RR 59-60. There was not even a legitimate business valuation book until the publication of Shannon Pratt's first edition of *Valuing a Business* in 1981.[1]

In assessing the ruling, there is considerable guidance on fundamental valuation issues. It seems that the drafters were familiar with some edition of *Security Analysis,* first published by

1 Pratt, Shannon P.. Valuing a Business: The Analysis and Appraisal of Closely Held Companies (New York: McGraw-Hill, 1981).

Professors Graham and Dodd in 1934.[2] This is clear in the detailed sections relating to analysis of the balance sheets and income statements of subject companies. Through the discussion of dividend-paying capacity, there is a focus on the net of cash flow items leading to that capacity.

A review of Revenue Ruling 59-60 is a good first step in understanding the standard of value known as fair market value. The ruling provides basic underpinnings for the broader and more detailed understanding of fair market value that has developed over the last several decades.

The entire ruling is presented in this paper in short excerpts. Following each portion from the ruling, my comments are indented and provided in italics. This material was originally written in the mid-1990s and was used as the text of an audio tape (yes!) series we published to provide CPE credit on the topic. We still have one of the original tape sets!

The original material has been edited and updated to present to my current thinking about what RR 59-60 says and does not say about the standard of value known as fair market value that it defines and describes.

- Z. Christopher Mercer, FASA, CFA, ABAR
April 2022

2 Graham, Benjamin, and David L. Dodd, *Security Analysis: Principles and Technique* (New York: McGraw-Hill, 1934).

Introduction to Revenue Ruling 59-60

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

This introductory material states that Revenue Ruling 59-60 ("RR 59-60") is applicable to the valuation of the common stock of closely held companies, or companies "where market quotations are not available" for estate and gift purposes. The revenue ruling is equally applicable to the valuation of businesses held in the form of S corporations, limited liability companies and partnerships.

To put this into perspective, there are about 5,000 companies that might be considered to have a public market for their shares in 2022. These shares are traded on the New York Stock Exchange, the American Stock Exchange, other exchanges, and on the NASDAQ over the counter markets. There are a few thousand more companies with thinly traded markets that trade through what are called the "Pink Sheets."

For perspective, when I first wrote this paper in the 1990s, there were about 12,000 publicly traded companies.

Beyond these public companies, there are more than a million businesses in America which are privately owned and have no market for their shares. RR 59-60 addresses the valuation of this vast segment of American business.

Section 1. Purpose

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

RR 59-60 is also applicable where market quotations are unavailable “or are of such scarcity that they do not reflect the fair market value.” The language of Section 1 suggests that if market quotations occur in sufficient volume, they may reflect fair market value. There is little guidance on what constitutes “sufficient volume” to reflect fair market value for a quoted security, so there is often a need or requirement for independent appraisal to facilitate gifting or other transactions involving the securities of nominally “public” companies where shares may be quite illiquid. The requirement for valuing shares of non-public, or privately owned shares is apparent.

Section 2. Background and Definitions

2.01. All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032 and 2512(a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

All valuations prepared for gift and estate tax purposes must be performed in accordance with the appropriate provisions of the Internal Revenue Code. This is fairly self-explanatory. Gift tax appraisals must be prepared as of the date of the gift; however, the code allows gifts to be made based upon appraisals prepared within sixty days of the gift. This convenient provision simply allows a bit of time between the receipt of an appraisal and the actual making of a gift of closely held stock. Owners of closely held businesses and their advisors should be aware that this provision enables appraisals made on the date of the gift, and also, no more than 60 days prior to the date of the gift. So, one appraisal can facilitate gifts made in two separate tax years (e.g., on December 31, 2021 and on January 3, 2022) based upon the same appraisal, which might be dated as of January 15, 2022. Some taxpayers use this provision to get double duty from their appraisals, and they conduct what amounts to annual gifting programs based upon appraisals that are obtained every other year.

Estate tax appraisals, which are always historical appraisals (because they are triggered by the death of a taxpayer), must be made as of the date of death of the owner of closely held securities. The only exception to this rule is that appraisals can be performed at the alternate valuation date, which is six months after the date of death.

Having said this, no one should rely upon my layman's interpretation of tax rules, and every reader of this paper contemplating valuations for gift or estate tax purposes should obtain competent tax advice. This paper is provided for informational purposes only, and should not be considered to be specific valuation, financial advisory, or (especially) tax advice. Such services are rendered in the context of specific situations, and the advice is always dependent upon the particular facts and circumstances of each situation.

2.02. Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

> *This definition of fair market value is quoted in many business appraisals and in many court cases. It is the definition from which shorter statements are derived. This definition establishes fair market value as an arms' length standard of value. Although it is not clear at this point, RR 59-60 defines fair market value in cash-equivalent terms. In the second to last sentence of the ruling (at the end of Section 8), we find that consideration for gift or estate tax purposes is defined as "adequate and full consideration in money or money's worth." That, in my book, is a cash-equivalent concept.*
>
> *A similar definition is found in the Glossary of the* ***ASA Business Valuation Standards****, published by the American Society of Appraisers (available at* www.appraisers.org*):*
>
>> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under any compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.
>
> *Business appraisers seek to mirror the hypothetical negotiations of hypothetical buyers and sellers in fair market value determinations. Neither the definition in RR 59-60 nor that in the* ASA Business Valuation Standards states it explicitly, but the hypothetical transaction(s) of fair market value occur on the valuation date(s), a term not mentioned until Section 4.

2.03. Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

> *The IRS is suspicious of the use of "market transactions" evidence involving family businesses. This suspicion arises because the pricing data derived from inter-family transactions often reflect low pricing. This low pricing is, in turn, advantageous to the taxpayer if considered in an estate tax or gift appraisal. Appraisers placing considerable weight on market transactions need to insure they are arms' length in nature to the extent possible*

Section 3. Approach to Valuation

3.01. A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide difference of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

The ruling establishes several points in Section 3.01.

1. *Valuation depends upon the facts and circumstances of each case.*

2. *The IRS stakes out a position against the use of formula appraisals.*

3. *Based on personal experience, appraisers are often directed to the "valuation is not an exact science" language on cross examination.*

4. *The IRS states that while appraisal is a fact-based endeavor, the elements of common sense, informed judgment and reasonableness, i.e., what I call the Critical Three Factors, are essential in weighing the significance of the facts. Too often, both IRS agents and appraisers overlook this important admonition in RR 59-60. As we shall see, the basic factors of valuation become virtually irrelevant if they are not considered in the context of common sense, informed judgment and reasonableness.*

3.02. The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

The general economic or industry outlook can affect the valuation of a company. Other things being equal, a company is worth more when the economy is strong than when it is weak. The same logic applies to local or regional economic conditions for companies like banks, construction and related businesses, retail-oriented businesses, and others, where local economic conditions strongly influence sales and earnings. In good times, financing is generally more available, which also has a positive impact on valuation.

The ruling states that uncertainty and value are negatively correlated. Other things being equal, a company whose earnings are stable and predictable is worth more than one with volatile earnings. The greater the riskiness associated with future earnings, other things being equal, the lower the conclusion of value.

Appraisers must assess risks based upon their consideration of the facts and circumstances applicable to the valuation subject as of the valuation date. Appraisers are once again warned that in the exercise of their judgment, they should be sure to consider all of the relevant information pertaining to the subject company.

3.03. Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

RR 59-60 clearly recognizes that the degree of uncertainty (or risk) impacts valuation. Value is inversely related to risk and uncertainty. Appraisers exercise judgment regarding the degree of risk, but such judgment must be exercised in the context of the facts and circumstances of the appraisal.

Appraisers should remember this section when applying average market earnings multiples from groups of larger, publicly traded companies to smaller private companies, particularly if the conclusion is not tempered by other valuation methods or procedures.

The first sentence of Section 3.03 suggests that valuation is prophesy (hopefully not heresy), and that an appraiser's forecasts should be "based upon facts available at the required date of appraisal." This is an interesting point. Since most tax-related and many litigated appraisals are "historical" before they are debated or litigated, performance subsequent to the valuation date is almost always known.

There is a very real temptation to look forward from an historical appraisal to validate or refute the valuation conclusion, depending upon which side of the argument one may be representing. Keep in mind that in many cases, the subsequent facts are actually known at the time the "historical" appraisal is performed. In many cases, one party has performed an appraisal in "real time," and a second party has access to subsequent performance at the time the second appraisal is conducted.

What I have learned is that if subsequent events tend to validate one of my appraisals, that evidence will not be allowed into the record. If the subsequent evidence is adverse, it will likely be introduced! Just call me cynical in this regard.

I believe that the information standard for historical appraisals should be to use information that was known or reasonably knowable at the valuation date. This is the only reasonable standard. Appraisers following this standard and documenting what was known (or reasonably knowable) at historical valuation dates have a reasonable probability of having their historical appraisals validated if the issue is later debated or litigated. We will discuss this key issue in more depth in my forthcoming book with the working title of Foundations **of Fair Market Value**.

The remainder of Section 3.03 (after the first sentence) has been the root of problems for many an appraiser and many an IRS agent. The logic of Section 3.03 goes like this:

1. *Market evidence related to freely and actively traded stocks provides a consensus outlook (and market pricing) for the underlying securities.*

2. *We don't have this kind of evidence for most closely held securities.*

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

There is nothing wrong with this logic. However, too many appraisers and IRS agents interpret this to mean that every small closely held company should be valued at the average multiple of earnings (however defined) of the public companies deemed to be "similar" or comparable.

Similar public companies can provide relevant market evidence in the valuation of private businesses. However, go back to Section 3.02 and review the commentary related to uncertainty (i.e., risk). If public guideline or comparable companies are used to provide pricing reference points for closely held businesses, the business appraisers who follow the advice of Section 3.02 and Section 3.03 must make a reasonable effort to equate the risks of holding the closely held security to those of holding the usually larger, more diversified, liquid securities of public companies with which the subject company is being compared.

The "risk analysis" can be accomplished in a variety of ways, ranging from adjusting the market multiples to weighing various methods. However, if valuations are consistent with the requirements of the Critical Three factors, common sense, informed judgment and reasonableness (Section 3.01), exercised in the context of all relevant information (Section 4.01 below), including uncertainty, or risk (Section 3.02), such adjustments must be considered and/or made.

We can make the same point about comparisons of expected growth between guideline public companies and subject private companies. For example, if the expected growth rate imbedded in comparable public company pricing is 8% per year and reasonable expected growth for a subject private company is 4%, it would be inappropriate to apply average public company multiples to the private company without adjustment.

Section 4. Factors to Consider

4.01. It is advisable to emphasize that in the valuation of the stock of closely held corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

I call the following factors the "Basic Eight" factors of appraisals because they are quoted in virtually every business appraisal and because they make so much sense.

a) The nature of the business and the history of the enterprise from its inception.
b) The economic outlook in general and the condition and outlook of the specific industry in particular.
c) The book value of the stock and the financial condition of the business.
d) The earning capacity of the company.
e) The dividend-paying capacity.
f) Whether or not the enterprise has goodwill or other intangible value.
g) Sales of the stock and the size of the block of stock to be valued.
h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

The Basic Eight factors should all be considered in the context of the overall valuation. Section 4.01 requires consideration of all the factors enumerated, consequently, they are outlined in nearly every valuation report. After that, however, they are too often ignored, and unreasonable and illogical valuation conclusions result. The above eight factors are discussed in more detail as the ruling continues.

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

Section 4.02 discusses each of the Basic Eight factors. The annotated discussion below breaks up the text of subparagraphs (a) through (h) in order to keep the commentary adjacent to the relevant text.

(a) The history of the corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business.

This sentence is consistent with Graham & Dodd, suggesting that the historical performance of a business sheds light on its outlook and "degree of risk." It focuses on *key analytical concepts such as historical "stability or instability," "growth or lack of growth," "diversity or lack thereof in operations," and other important factors.*

It is clear that RR 59-60 requires a fairly thorough historical analysis of a company's financial performance and operations. Historical performance is the well from which future performance springs. It provides a basic direction or velocity of performance, either favorable or unfavorable. From this foundation, the appraiser must make reasonable judgments regarding expected future performance.

Value is a function of expected cash flow, the risks associated with achieving those cash flows, and the expected growth of those cash flows. In this first of eight factors, RR 59-60 focuses on two of the three valuation factors.

For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered.

In other words, the analyst may have to dig to get at the actual historical performance of an enterprise.

The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable.

Detailed financial and operating data should be reviewed and analyzed for at least four to six years preceding the valuation date, if available. For cyclical businesses, it may be appropriate to review sales, earnings, margins and returns over a longer period to understand the nature of a business and where it currently stands in its business cycle. Finally, the most current results and conditions may have the greatest impact on the outlook for the future. So, the analyst must study the current situation carefully, but in the context of historical results and the outlook for future performance.

The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operation and investment assets, capital structure, plan 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.

The factors mentioned are self explanatory and fundamental to understanding any business. The business appraiser needs to understand the nature of and reasons for significant changes, many of which will be reflected in the historical financial statements of the business being studied.

The information reviewed should be current "as of the date of the appraisal." I mentioned earlier a standard of considering facts that are "known or reasonably knowable." An example will help clarify this point. Assume that the valuation date for a company is December 31, 2021. As of the date of the appraisal, the 2021 audit was not available. However, in an historical appraisal, the year-end audit, which may not have been issued *until April 2022, will almost invariably be considered as appropriate for use at the (historical) valuation date of December 31, 2021. The information in the audit will be considered "reasonably knowable" as of the valuation date.*

For valuation dates past fiscal year-ends, it may be appropriate to consider the financial statements for the most recent quarter-end or month-end prior to the valuation date. The financial statements used may depend upon the actual or perceived reliability of interim, internal and unaudited financial statements for each particular company.

A slightly different standard may apply if, for example, a valuation is being issued as of December 31, 2021, and the report date is January 5, 1995. In other words, the report is being issued in real time. The most recent financial statements as of the valuation date would be the November 30, 2021 eleven-month statements. The best estimate of full year 2021 may be represented by the income statement for the twelve months ended November 2021. The December 2021 financials have not yet been issued, and the 2021 audit is certainly not available. Under these circumstances, the appraiser's investigation and documentation will be critical if the appraisal is later questioned and the 2021 audited results vary significantly from the estimates based upon results for the trailing twelve months ended November 2021.

In other words, it is incumbent upon the appraiser who is issuing "real time" appraisals to establish clearly and convincingly in his or her report what was actually known based upon reasonable investigation.

The concept of "known or reasonably knowable at the valuation date" becomes slippery when historical appraisals are performed. There is a real difference between things that are ***possible*** *in the future from the vantage point of the valuation date and things that are* ***knowable*** *at that date. For example, a future transaction involving shares in a company's stock may be* ***possible*** *at the valuation date. However, if a transaction that was* ***possible*** *occurs a year* ***after*** *the valuation date, there is a temptation to believe that since it occurred, then it was also* ***knowable*** *at the valuation date.*

An Example of "Known or Reasonably Knowable at the Valuation Date"

The investment world is focused on what is known or reasonably knowable at any valuation date. In August 2019, I purchased shares in a public company named One Spa World at a price of about $15 per share with the thought of it being a long-time hold.

The stock traded at $15.26 per share on February 14, 2020 before taking a precipitous fall to a low of $2.60 per share on April 3, 2020. What happened? On March 11, 2020, the COVID-19 virus was declared a pandemic by the World Health Organization, and by March 20, 2020, lockdowns had begun in the United States. Prior to that, there was growing coverage of the virus in the national and international press.

Did I mention that One Spa World was a leading provider of spa services on cruise ships around the globe? When I looked at the stock price in mid-April 2020, it was trading in the $4 per share range.

> *The example is personal; however, it is illustrative of the concept of "known or knowable at the valuation date." In August 2019, I was not aware of the existence of a virus strain that would be named COVID-19. In retrospect though, it could look as if I should have anticipated the pandemic and avoided the stock. The first COVID-19 cases were disclosed in Wuhan, China on December 31, 2019. The first case in the United States was identified on January 20, 2020. There was constant news during the first quarter of 2020. Obviously, other investors recognized the potential for the virus to have a significant impact on One Spa World by February 14, 2021, while I was blithely not looking at its share price every day.*
>
> *Nevertheless, the question is, what was the market price of One Spa World in August 2019? Well, it was in the range of $15 per share. I purchased the stock based on what was known and reasonably knowable at the recommendation of an investment manager who had studied the stock in depth. Does the fact that the pandemic occurred change what was known or reasonably knowable at my purchase date? Of course not. Do I blame the investment manager? Of course not.*[3] *She bought far more stock for her firm's portfolio than I did. Both of us acted on what was known or reasonably knowable when we made our investment decisions.*
>
> *The bottom line is that the fact that events occur* ***after*** *a valuation date does not change what was known or reasonably knowable* ***at that valuation date.*** *Appraisers, the Internal Revenue Service and the U.S. Tax Court would do well to ponder these observations when confronted with post-valuation events where there is a temptation to think that historical valuations should be determined or impacted by their occurrence.*

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

> *Events that happened in the past but are unlikely to recur in the future are called "non-recurring events." More judgment is called for here than is at first apparent. Items categorized as "extraordinary" by a company's accounting firm will almost always fall appropriately into the "non-recurring" category. But a multitude of other events can also be considered as non-recurring. The life of a business is filled with many events which, if considered in isolation may appear to be non-recurring. However, in the context of actual operations over time, such events may actually be part of normal business. I have jokingly said many times that the life of a business is filled with one non-recurring event after another, each and every one of which costs or gains money. Appraiser judgment is critical in the determination of non-recurring events and their impact on the outlook for earnings in the future.*

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3 All is not lost. I doubled down at just over $4 per share with full knowledge that there was a pandemic and my belief that it would not put the cruise line business out of business for more than a year or two. The stock is trading at about $10 per share as I am writing this note and there is a 35% gain on the overall position. It is still a long-term hold in my portfolio.

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied.

> *A sound appraisal will include an examination of economic conditions and outlook as of the date of the appraisal. This analysis will include a consideration of the national economy and the economic factors (such as the level or direction of interest rates, housing starts, or consumer confidence) which most influence a subject business. It will also include, if appropriate, a consideration of local or regional economic conditions. Finally, it is important to understand the general condition and outlook for the industry or industries within which a subject company operates. Business appraisers must conduct an ongoing national economic analysis and be able to research conditions in specific industries and geographic locations. Mercer Capital, for example, has published its quarterly* ***National Economic Review****, which is used by appraisal firms across the nation, for many years.*

It is important to know that the company is more or less successful than its competitors in the same industry or that it is maintaining a stable position with respect to competitors.

> *Where data is reasonably available, appraisers must compare a subject company's performance with other companies in the same industry. Many appraisers use Robert Morris Associates data, which covers about four hundred industry groups, for such comparisons. Other industry-specific data is also available for many industries through trade associations or other data sources which specialize in those industries.*
>
> *Appraisers should not forget, however, that performance comparisons with industry groups may be rendered less relevant if valuation parameters are based upon comparisons with a specific group of publicly traded companies. In that event (as will be discussed below), the appraiser must analyze the subject's performance in relationship to the selected group of public guideline or comparable companies.*

Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries.

> *Is the industry declining or prospering? The subject company may be the dominant company in the cast iron skillet manufacturing industry, but other forms of cookware (stainless steel, copper, etc.) and other means of cooking (microwave and eating out) may override this seemingly favorable fact.*

Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition.

> *High margins tend to attract competition, which can have a significant impact on the growth outlook for established businesses in an industry. Is the overall market growing fast enough for the established business to sustain reasonable growth? Are the trade*

secrets becoming known? Is the company in a fad industry? Like hula hoops or crock pots? These can be important questions for the business appraiser's consideration.

Further, there is a financial concept called the "reversion to the mean." Above-normal margins, for example, may be discounted somewhat because of the tendency of margins to revert to some mean level, either for a company or for an industry. Above-normal margins are real but are often considered to be riskier than more normal margins.

The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities.

Given a specific industry group, it can be important to look at the outlook for specific competitors within the industry or for industries that may be competitive. Industry pricing trends and the trends of the stocks of companies in the subject or competitive industries may have an impact on value. In such cases, research and judgment will be the keys in assessing the impact upon fair market value.

The loss of the manager of a so-called "one-man" business may have a depressing effect on the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration.

It is clearly important to determine if the subject company is "key-man" or key person dependent. Many closely held businesses, especially the smaller ones, are key person dependent, at least to a degree. Key person dependencies can result from a founder's influence on sales, marketing, product development, or simply management control. If a key person retains all decision-making authority, subordinate managers will not develop and gain the confidence and experience necessary to reduce key person issues over time.

Other things being equal, a key person dependent company is more risky, and therefore, worth less than a similar company with a well-developed management team. Recognition of key person dependencies requires investigation and the exercise of appraiser judgment. Some court cases have allowed specific "key man" discounts in valuation. However, there is little or no empirical data to support such direct discounts. Generally, key person dependencies, like other risks, should be considered in the overall capitalization rate applied to earnings and/or in the weightings applied to different valuation methods. Key person risks can also be considered through the potential loss of revenue (and earnings) in the absence of the key person.

In any event, business appraisers need to address the issue of key person dependency when it exists and treat it carefully and thoughtfully in their appraisals. (Business owners should also recognize that by failing to develop subordinate management and decision makers, they may be devaluing their most valuable asset.)

On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

This guidance regarding offsets to key person risks is clear and hardly needs restating or amplification.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit.

Appraisers should generally examine a minimum of four to six years of financial statements, including balance sheets, whenever available. Sometimes appraisers look at several years of income statements, and only a current balance sheet. But balance sheet trends are also important in the overall assessment of value. Appraisers should be careful to ensure that interim balance sheets (and income statements) are adjusted to be consistent with the audited or other financial statements prepared at the end of fiscal years. Such differences, which may be the result of annual accruals of depreciation, insurance, management bonuses, taxes, or other factors, need to be interpreted appropriately if reasonable valuation conclusions are to be reached.

In addition, historical and current balance sheets may provide evidence of excess or non-operating assets which should be considered in a valuation. On the downside, the historical balance sheets may provide evidence of underinvestment in plant and equipment or less than adequate working capital.

Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules.

Balance sheet (and income statement) detail should be presented by the appraiser in schedules which facilitate understanding by the users of appraisal reports. Many critical facts about a business which can have a significant impact on value are presented in the notes to audited, reviewed or compiled financial statements. This data needs to be summarized in the schedules presented or discussed specifically in the text of an appraisal report. Unfortunately, many appraisers do not present the detail called for by RR 59-60 in their appraisals.

These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth.

This brief section provides a few examples of balance sheet driven ratios which can impact valuation. There are many other fairly standard analytical ratios that should be presented by the appraiser of closely held businesses. What is important, however, is for the appraiser to assess the relative importance of balance sheet trends and current financial position, including financial leverage, in the overall valuation.

Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such non-operating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true.

***Non-operating assets** are singled out for specific treatment. Non-operating assets can include boats, planes, resort condominiums, investments in real estate limited partnerships and shutdown production facilities. Another form of non-operating assets can be labeled **excess assets**. Examples of excess assets include cash held beyond ordinary operating requirements, land held for investment purposes, common stock, and other investments not directly related to the operation of a business.*

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

The "book value" of a company's stock is generally agreed to be the total value of its assets, at their historically depreciated cost basis, less total liabilities. The sentence regarding "book value" in the ruling confuses the term with a partial form of adjusted net asset value, which calls for assets of the investment type (presumably, certain non-operating or excess assets in an operating company) to be revalued on the basis of current market pricing. In an operating company, it may also be appropriate to adjust major operating assets such as real estate, inventories, accounts receivable, or machinery and equipment to their current market values. Further, it may be necessary to adjust above- or below-market liabilities to current market values, as well.

The guidance of this sentence seems to apply to real estate or investment holding companies. Most appraisers apply these suggestions to operating companies, as well.

Not addressed in this guidance is the issue of imbedded tax liabilities (or potential tax benefits) resulting from the realization of the current value of assets which are owned in the corporate form. Imbedded tax liabilities (or potential benefits) can have a significant impact upon the value of a corporation's shares from the viewpoint of a purchaser who cannot realize the value of appreciated assets. For example, the sale of appreciated assets may trigger adverse tax consequences, which would tend to lower values. The IRS has sometimes argued that since such tax consequences may or may not ever be realized, they should be ignored. In the context of determining fair market value, I believe that the issue of imbedded taxes should be addressed directly by appraisers. They do not necessarily *have a direct, dollar-for-dollar impact on value, and may be mitigated by the facts and circumstances of a particular situation or by the weightings to be applied to various valuation methods. Nevertheless, they should not be ignored, particularly if the appraiser believes that the current values of balance sheet items differ materially from their historical (book) values.*

Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation.

RR 59-60 calls explicitly for the examination of balance sheets over several years. Such an examination is an integral part of the in-depth financial analysis required in a determination of fair market value.

This text indicates that balance sheet analysis can reveal information about the acquisition of production facilities. In combination with a review of revenues, earnings, and cash flows, it can also reveal, for example, the prospective need for additional investments in fixed assets or working capital.

The point is that the analyst must analyze the balance sheet (and related financial statements) over a long enough period to understand not only the current position of a business, but also the trends in place leading to the current position, and their potential impact upon future prospects and value.

If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

The charter, certificate of incorporation, and/or the by-laws of a corporation (as well as other agreements which impact rights of ownership of equity or debt securities) should be examined to determine if there are any peculiarities of legal structure that could affect value.

This examination is even more critical if a company has a complex capital structure. The preferences regarding voting rights, dividends or liquidation noted above may apply to different classes of common stock or to preferred stock. In addition, a company may have stock which can convert into common stock (or another class of stock) upon the realization of certain events. Further, there may exist warrants to purchase additional shares, or stock options that need to be considered, together with the capital that their exercise might generate.

Revenue Ruling 83-120 provides some guidance regarding the valuation of preferred stocks, and, by implication, certain long-term debt instruments. It is sometimes necessary to value one or more issues of preference securities to determine the fair market value of the underlying common stock.

In cases where two classes of common stock differ only with respect to their voting privileges, the difference(s) may cause a differential in valuation and must be considered. There is little practical or theoretical guidance regarding value differentials resulting from voting differences. We have examined examples of companies where both the voting and the non-voting shares are publicly traded. Often, there is a small pricing differential in favor of the voting shares. Appraisers often make a small, judgmental adjustment (e.g., 2% to 3%) to reflect the lower value of non-voting shares relative to otherwise identical voting shares of private companies.

Issues regarding complex capital structures can be, well, complex. Nevertheless, they must be considered appropriately in determinations of fair market value.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years.

This guidance is fairly explicit and conforms with earlier comments regarding historical analysis.

Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profit taxes; (3) net income available for dividends; (4) rates and amount of dividends paid on each class of stock; (5) remaining amount carried to surplus and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet.

It should be clear (from (1) and (2) above) that in a determination of fair market value, the analyst must review the nature and sources of a company's revenue stream, its cost of goods sold (if applicable), and the details of its operating expenses. In other words, there should be a detailed income statement analysis corresponding to the balance sheet review noted above. Revenue and expense items should be examined in dollar terms, in the form of margins (e.g., as percentages of sales or assets), and in terms of relative growth rates over time.

Items (3) to (6) above, by focusing on net income available for dividends and actual dividends paid (or earnings retained by a company) and various adjustments to equity suggest that the analyst should study the cash flows of the business under consideration, in addition to its earnings. While the language does not focus on cash flow, it should be clear that an analysis of "net income available for dividends" requires an understanding of the working capital and capital expenditure requirements of a business enterprise.

With profit and loss statements of this character available, the appraiser should be able to separate recurrent from non recurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company.

The first portions of this sentence dealing with recurring versus non-recurring items and distinguishing between operating income and investment income, is a reemphasizing of earlier guidance. At this point let me point out to appraisers and to readers of appraisal reports that there is a correlation between the balance sheet and the income statement. Many balance sheet adjustments require a corresponding income statement adjustment. For example, investment assets or excess cash are often segregated from operating assets and added to value at the end of an analysis. Such treatment requires appropriate adjustments to the income statement (i.e., eliminating the associated income and/or expense associated with the investments) to avoid capitalizing their earnings together with operating income.

The phrase dealing with money-losing operations can lead to a business appraisers' version of "Never Never Land". It is certainly important to understand profitability by division or line of business, and to focus on money-losing operations for further discussion. But it can be dangerous for an appraiser to speculate about lines of business which might be abandoned "with benefit to the company." Sometimes, money losing operations are just that - money losers. Alternatively, a money losing operation today may be the acorn from which future growth will come. Few companies make money in every line of business and every division all the time. Appraisers should be careful when speculating about the impact of abandoning lines of business, particularly if working through money losers is a normal way of finding winners. In addition, the appraiser who values a company upward as a result of omitting losses of a line of business or division should be careful to consider the ongoing losses until a possible disposition as well as the costs of disposition or shut down.

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

We will discuss this factor in more depth a bit below.

Potential future income is a major factor in many valuations of closely held stocks and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power.

The past performance of a company often provides the best available evidence regarding its expected future performance. Some of the trickiest issues in valuation lie in the interpretation of historical performance to develop current estimates of earning power which properly reflect past performance and future prospects. Consider the following situation involving a company with increasing earnings and margins in recent years.

	Most Recent Year	Last Year	Two Years Ago	Three Years Ago	Four Years Ago
Sales	$7,320	$6,655	$6,050	$5,500	$5,000
Earnings and Margins					
Net Income	$586	$466	$363	$275	$200
Net Margin (%)	8.0%	7.0%	6.0%	5.0%	4.0%
Growth Rates					
Sales (%)	10.0%	10.0%	10.0%	10.0%	10.0%
Net Income (%)	25.8%	28.4%	32.0%	37.5%	15.0%

In this example, sales have been growing at a 10% rate for the last five years. Margins, however, have been improving, so the growth rate in earnings was very rapid, although slowing toward the most recent year. How does an appraiser value a company like this? I would suggest carefully.

Weighting Schemes	Year 1 Implied Net Earning Power	Alternative Weightings					Implied Values at 10x	Implied Net Margin	Year 5 Earnings Forecast
Most Recent Year	$586	1	0	0	0	0	$5,860	7.6%	$748
Simple Average	$378	1	1	1	1	1	$3,780	4.9%	$482
3-Year Wtd Average	$509	3	2	1	0	0	$5,088	6.6%	$649
5-Year Wtd Average	$442	5	4	3	2	1	$4,422	5.8%	$564

The table above shows four different earnings estimates based on four different weighting schemes for historical net income. For purposes of this example, assume that the implied earning power from each weighting is the appraisers estimate of ***next year's*** *earnings. Which one is right? Depending upon the facts and circumstances faced by the appraiser, any one of the estimates above could be reasonable. Which average is "arbitrary?" Again, any one or all of them could be arbitrary, depending upon the facts of the case. Most recent year earnings exceed the simple average of earnings by 55%, the 3-year weighted average by 15%, and the 5-year weighted average by 33%. We could increase complexity by weighting historical margins, as well.*

We can add examples showing cyclical earnings or declining earnings trends, but the point is clear. The appraiser must exercise considerable judgment in the selection of earning power estimates. Remember that the purpose of any estimate of ongoing earning power is to develop a proxy for ***expected future earnings.*** *If any of the above estimates are capitalized based on an equity discount rate and a long-term expected growth rate, a forecast of future earnings is being made. That statement bears repeating. Every time the single-period income capitalization method is used to derive an indication of value for a business, there is an implicit forecast of earnings into the future.*

Assume that the appropriate discount rate is 15% and the expected long-term growth rate is 5%. The appropriate valuation multiple is therefore 10x. (M = 1 / (r – g) = 1 / (15% - 5%)= 10.0x)

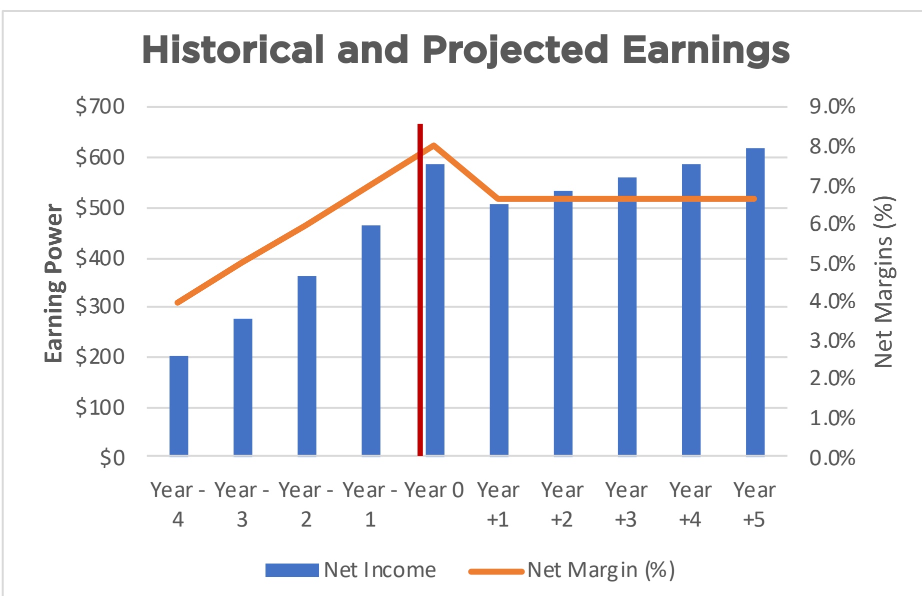
Based on this multiple, the four weighting schemes above yield implied values for the business ranging from $3.8 million to $5.9 million, a hefty swing. The table above shows the implied next year earnings based on each of the implied estimates of earning power. Note also that we have shown the implied earnings in the fifth year of the forecasts in the table above.

- *The current year earnings of $586 thousand are never reached with the simple average (fifth year is $482 thousand) and the 5-year weighted average (fifth year is $564 thousand).*

- *The implied margins for the first and future years are shown at the right of the figure. Based on the simple average of earnings, the implied net margin is 5.2% (relative to the most recent year's net margin of 8.0% and the implied margin of 7.6% for the most recent year).*

- *The implied margin for the five-year weighted average scheme is 5.8%, and the implied margin for the three-year weighted average is 6.6%.*

Assume that the appraiser concludes that the three-year weighted average weighting scheme best fits the facts of the case. The net margin, which has grown to 8.0% in recent years, is expected to revert to a lower, long-term margin of 6.6%. Based on this weighting scheme, the implied fifth year earnings are $649 thousand. The implied forecast based on this assumption is shown in the next figure. Appraisers, attorneys and judges should know that these simple calculations can be made for any single-period income capitalization method.



Do not be misled by those who would say: "Let's not worry about this difficult look at the past. We'll just forecast earnings for the next few (how many?) years and discount those earnings (or cash flows) to the present." Does the problem of potential arbitrariness go away? Emphatically, no! Then the forecasted revenues, margins and earnings (and cash flows) must make sense in the context of historical results, just as they must make sense with the implied forecast above.

The use of the discounted cash flow method has increased markedly over the last twenty years or more. The DCF method was rarely used when RR 59-60 was written, and the concept is not found directly in the ruling. However, by saying that valuation of securities is "a prophecy as to the future," the ruling definitely understood that valuation was forward-looking.

It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

I think this section is suggesting that a detailed analysis of the historical percentage income statements will be helpful in assessing risk and earning power. If so, I agree.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

When examining dividend-paying capacity, it is also necessary to focus on requirements for earnings retention. Analysts sometimes make a serious mistake when capitalizing a measure of dividend-paying capacity. Dividend capacity is often measured by reference to average dividend payout ratios of publicly traded guideline companies. If the subject company is highly leveraged or is facing heavy capital expenditure requirements, the analyst runs the danger of capitalizing "dividends" which never would or could be paid.

The drafters of RR 59-60 knew that dividend-paying capacity was important, but implicitly warned of capitalizing that capacity directly in valuations of minority (i.e., non-

controlling) interests. I believe their focus was on expected cash flow, which recognizes other uses of cash like working capital and reinvestment for growth and to remain competitive.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of tangible value.

The original version of RR 59-60 contained the following language: "In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets."

The quoted sentences were deleted from Rev. Rul. 59-60 by Rev. Rul. 65-193, 1965-2 C.B. 370 with the following explanation: "The instances where it is not possible to make a separate appraisal of the tangible and intangible assets of a business are rare and each case varies from the other. No rule can be devised which will be generally applicable to such cases."

I would offer this suggestion: there is no such thing as automatic goodwill. Some companies are worth more than their net book value, and some are worth less. Earnings (or their prospect in the eyes of potential purchasers) are the primary source of goodwill. Capitalized earnings value in excess of the net book value of a business (at depreciated historical costs) is the definition of goodwill embraced by RR 59-60.

One of the Basic Eight Factors of the Ruling is a consideration of: "whether or not the enterprise has goodwill or other intangible value." However, any determination of the existence of goodwill is usually the (indirect) result of the appraisal process rather than the subject of direct investigation.

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation.

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

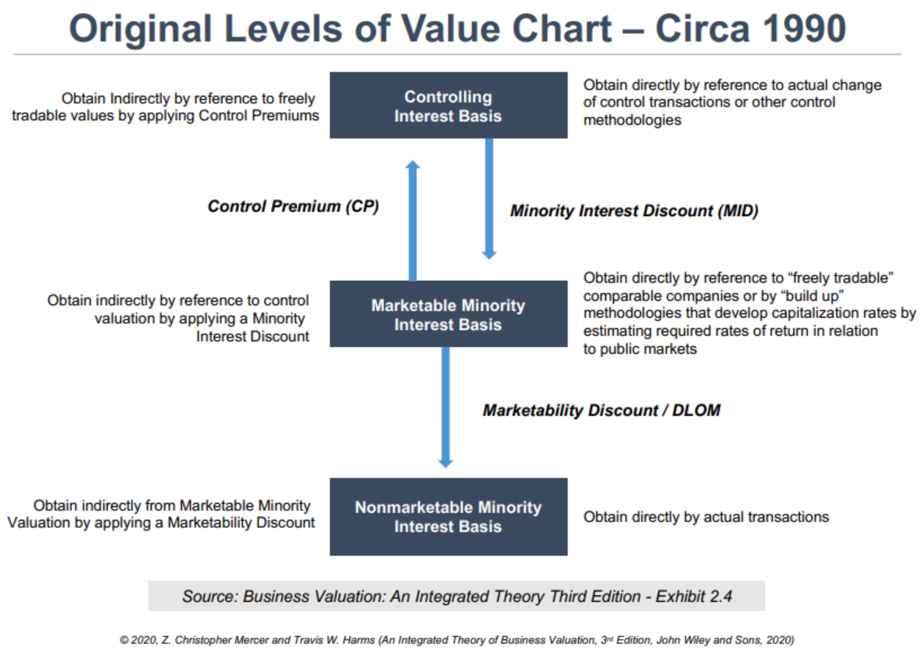
Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

RR 59-60 is the definitive ruling regarding the valuation of business interests for estate tax and gift tax purposes. Yet its entire guidance with respect to the critical valuation concepts of control premiums, minority interest discounts and marketability discounts is contained in the last sentence above!

Let's repeat it for emphasis: "Although it is true that a minority interest in an unlisted stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher price for a specific block of stock."

This section does appear to embrace the "conventional wisdom" of valuation which suggests there are three basic levels of value. The drafters get a pass on not mentioning levels of value. A formal levels of value chart was not published by an appraiser until 1990![4] That chart is shown below.

4 I published this chart in an article in the *Business Valuation Review* in 1990. A similar chart was published that year in a book edited by James Zukin. I am aware of no earlier published versions of this conceptual chart.



The implied reference point here is of a freely tradable, listed security with an active market for its shares. That is the middle level of value which can be described as that of a "marketable minority interest," or "as if freely tradable."

Non-marketable minority interests are worth less because of their illiquidity and represent the lowest level of value. The concept of the "marketability discount" is applied to the marketable minority interest value to obtain the value of illiquid minority interests in closely held businesses.

Note, however, that there is no specific mention of the concept of a "marketability discount" at this point in RR 59-60.

The highest level of value is called the controlling interest, or enterprise level of value. It was then thought to be arrived at by adding an appropriate control premium to the marketable minority interest level of value. Both the concept of the control premium and that of the marketability discount have been addressed in numerous studies by appraisal professionals and by the various courts.

These concepts have evolved considerably in recent decades. The conceptual levels of value and the economic reasons for implied control premiums and marketability discounts are discussed in depth in ***Business Valuation: An Integrated Theory Third Edition****.*[5]

Revenue Ruling 59-60 was amplified by Revenue Ruling 77-287 nearly twenty years later. RR 77-287 deals with the specific problem of valuing restricted shares of publicly traded companies, where the only difference between the restricted, or unregistered shares and

5 Mercer, Z. Christopher, and Travis W. Harms, *Business Valuation: An Integrated Theory Third Edition* (Hobokken, NJ, John Wiley & Sons, 2021).

their freely trading counterparts is the restriction on marketability. Somehow, this amplification of RR 59-60 managed to avoid using the term "marketability discount" altogether! It does, nevertheless, contain some useful information on the analysis of restricted securities. It also references and summarizes some information from the SEC Institutional Investor Studies of the late 1960s and early 1970s that has long been quoted in support of marketability discounts for minority interests of closely held businesses. All this, and still no mention of marketability discounts! One can ask if the IRS is engaging in avoidance, or perhaps, denial. But one cannot avoid the conclusion that the bias in RR 59-60 against marketability discounts was continued in the amplifying RR 77-287![6]

(h) Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or similar line of business which are listed on an exchange should be taken into consideration along with all other factors.

The fundamental premise of this statement is that we can obtain information about the value of private securities by appropriate comparisons with the securities of publicly traded companies. Interestingly, there is no mention in all of Section 4.02(h) of the underlying reason we look at public companies when valuing private businesses.

We live in a world of alternative or competing investments. In concept, the ideal alternative investment with which to compare an interest in a closely held business is an identical interest in a public company that is the same or very similar to the private one. Why? We know the price of the public security and should be able to rely on that pricing if there is an active market for its shares. We therefore use public companies as "guidelines" to develop valuation multiples, or capitalization rates (which are not addressed until Section 6 of the Ruling).

The statement above first suggests that comparisons should be made with "corporations engaged in the same or similar line of business". Such comparisons are often difficult to make. In many instances, the analyst simply cannot identify public companies in the same business as a subject private company. In other cases, while a public company may have a division or subsidiary that is in the identical business, it represents such a small portion of the public entity's business that comparisons are not meaningful.

Analysts sometimes attempt to use the "or similar line of business" guidance to identify public companies with similar marketing, manufacturing, distribution, or other characteristics. But neither this guidance nor common sense suggests that analysts should use what I call "market basket groups" of companies when more specific comparability in the public markets cannot be identified. For example, it would rarely be appropriate to use market data for broad industry group of publicly traded manufacturers as a basis to develop a capitalization rate for a small, closely held manufacturing business.

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6 Mercer, Z. Christopher. *A Current View of the Restricted Stock Studies and Restricted Stock Discounts.* Business Valuation Review, American Society of Appraisers. Volume 40, Issue 2, Summer 2021.

Finally, the initial sentence of Section 4.02(h) suggests that guideline companies should be listed "on an exchange." Recall, however, that this was published in 1959, when the over-the-counter markets were much smaller and less liquid than today.

An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date.

The guidance regarding the selection of comparable companies which are "actively traded by the public" is quite clear. In today's market environment, this requirement is met by most companies on the national NASDAQ market, as well as many other companies in the over-the-counter markets. While a conclusion that a public company has an "active market" is a matter of judgment, price and volume data, as well as information regarding market makers and research following by investment banking firms is available for all public securities. In other words, there is readily available information to assist the business appraiser in making the judgment of whether a stock has an "active market."

In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained.

"Other relevant factors" include size, market capitalization, capital structure, operating characteristics and the like. For example, an analyst should question the comparability of public companies with market capitalizations of several hundreds of millions of dollars (or billions or, in 2022, a trillion or more, whatever that is!) with a $10 million sales private company, even if the line of business match is exact.

In developing guideline companies from the public markets, experienced analysts typically go through a series of "screens" to insure comparability with a subject private business. For example, if the subject company is a $20 million business in some aspect of the flexible packaging manufacturing industry, the successive screens might resemble the following: 1) Screen all public companies for a primary line of business in the subject's SIC Code. This screen might yield one hundred or more "suspects." 2) Because the subject has only $20 million in sales, we might eliminate all companies over, say, $500 million in sales as too large for meaningful comparison. 3) Assume that the subject has been consistently profitable for the last five years. We might screen the remaining public companies for this requirement. 4) The subject company has an average operating profit of 7.5%. We might further screen the public companies for operating profit margins of 10% or less. 5) At this point we might study detailed descriptive and financial information on the remaining publics and eliminate those which are obviously not comparable. 6) Finally, we would *determine the necessary additional screens that objective analysis of the public companies suggests in the context of the subject private company.*

When all these screens have been accomplished, we might have a remaining group of as small as 3 or 4 "comparables" or as many as 10 or 12 or more. The key is that just because a public company is in the same or a similar line of business as a subject private company, it may not be a reasonable source of comparative valuation data unless it passes the tests of "other relevant factors" as outlined above.

For illustration, a corporation having one or more issues of preferred stock bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

The genesis of this guidance is unclear. In today's public markets, some companies have preferred shares or other securities with certain preferences relative to common stock. Given the availability of detailed financial disclosure on public companies, the existence of preferred securities would not seem to be a reason for dismissing a potential company as a guideline public company.

Section 5. Weight to Be Accorded Various Factors

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

> *After several pages of fairly specific guidance, RR 59-60 begins to run a little thin. Suffice it to say that the relative weights to be accorded earnings-based indications versus other indications, including asset-based indications of value, can differ depending upon: 1) the purpose of the appraisal; 2) the degree of anticipated earning power in relationship to asset values; 3) the type of company (e.g., operating versus holding); 4) the nature of the assets in question; and 5) numerous other factors. Judgment is clearly required in the application of weights to various valuation indications.*

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock.

> *It is hard to argue with these statements in general. But notice that Section 5(b) begins with "the value of the stock," just as if there is such a thing as "the value" of that stock. The same guidance might have been offered for partnerships or partnership interests. In the comments above, we have seen that there are at least three levels of value which can apply to the same stock at the same time! Which value is the ruling addressing? While it does not say so, for holding companies, the ruling is really talking about the controlling interest or enterprise level of value. But most valuations of real estate or investment holding companies performed for gift tax or estate tax purposes relate to the lowest level of value, or the non-marketable minority interest level. Is this a mistake, simply confusion, or bias in the ruling? The reader can be the judge!*

For companies of this type, the appraiser should determine the fair market values of the assets of the company.

> *Clearly, the appraiser of an investment or real estate holding company must have an understanding of the current market values of the underlying assets. In the case of an investment holding company, the business appraiser may be able to value the underlying assets directly. A real estate appraiser will normally need to be retained for real property assets if other current and reliable indications of value are not available.*

Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets.

> *This sentence acknowledges that there is a layer of ownership between the holder of stock in a real estate or investment holding company (or partnership) and the underlying assets. This layer of ownership raises once again the issue of control of the subject entity, which provides access to the direct realization of the underlying assets. However, as above, the ruling is silent on the issue.*
>
> *Excessive operating expenses in a real estate or investment holding company (or any company!) can have a material adverse impact on value, especially from the viewpoint of minority shareholders who have no control of nor benefit from the excess expenses.*
>
> *Finally, the last sentence of text mentions liquidation costs, if any. Liquidation costs may or may not be relevant or material. However, when valuing the stock of an investment or real estate holding company, liquidation costs are inherent in realizing the underlying asset values. In the gift and estate tax arena, liquidation costs may be a difference between fair market value and proceeds, net of deductible liquidation expenses.*

The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

> *This last portion of Section 5(b) once again begs the question, when discussing the weights to be accorded various indications, of the level of value being addressed. The text once again refers to the controlling interest level of value and makes no mention of issues related to the illiquid nature of most minority interests in closely held businesses (and the need for marketability discounts).*
>
> *The absence of any discussion of minority interest discounts and marketability discounts in RR 59-60 is striking. The text as written allows for considerable confusion over these issues by not addressing "value" at its various levels.*

Section 6. Capitalization Rates

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation.

> *Section 6 begins by acknowledging that the development of appropriate capitalization rates is one of the more difficult aspects of valuation. Nevertheless, this difficult subject gets a total coverage of seven sentences in RR 59-60!*

That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporation shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions.

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

Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

> *Conceptually, we can represent the basic valuation equation as:*

$$V = f((E \times M); O)$$

> *Where V = value; E = an appropriate representation of earning power; M = an appropriate multiple to be applied those earnings; and O = consideration of other factors such as asset values. Up until Section 6, the emphasis of RR 59-60 has been almost exclusively on the E and the O, i.e., the development of earning power and the consideration of other important factors. Now, in the next-to-last section of the ruling, treatment of M, the critical multiple to be applied to earnings, is cryptic at best.*

Again, in fairness to the drafters of RR 59-60, the use of the capital asset pricing model to "build up" discount rates was nascent, at best. To the best of my knowledge, I wrote the first article detailing how to use the capital asset pricing model to develop discount rates for private company valuation in 1989, or some 30 years after the publication of the ruling.[7]

Our objective today is to talk about what RR 59-60 does and does not say. A more detailed discussion of the development of capitalization rates is therefore beyond the scope of this paper.

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7 Mercer, Z. Christopher Mercer. *The Adjusted Capital Asset Pricing Model for Developing Capitalization Rates: An Extension of Previous 'Build-Up' Methodologies Based Upon the Capital Asset Pricing Model*. Business Valuation Review, American Society of Appraisers. December 1989

Section 7. Average of Factors

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end results cannot be supported by a realistic application of the significant facts in the case except by mere chance.

> *This brief section can best be described as inane. The purpose of any fair market value determination is to develop a conclusion of value for a specific equity interest for a specific purpose as of a specific point in time. How else can an analyst synthesize often disparate value indications such as low capitalized earnings and high net asset values, or the reverse, high capitalized earnings and low net asset values, except by some explicit or implicit averaging process? Some appraisers make their averaging explicit. Others, by selecting a conclusion within a range of indicated values, use an implicit averaging process. How else could they pick a value at the upper end or the lower end or the middle of the range? I have read hundreds of appraisal reports by appraisers from all over the country. The reports were prepared by sole practitioners, members of small firms, Big 4 accounting firms, other large and small accounting firms, larger valuation firms and IRS engineers. Actually, all appraisers use some form of averaging process to synthesize their valuation conclusions. The guidance of this paragraph can be safely ignored.*

Section 8. Restrictive Agreements

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer.

> *Restrictive agreements applicable to closely held shares should always be considered by the appraiser in determinations of fair market value. Sometimes such agreements can be determinative of value as with a binding buy-sell agreement that is adequately funded and determinative of the pricing of transfers among shareholders. At other times, the existence of restrictions on transfer can be detrimental to value. For example, if the restrictions are such that it is difficult to entice qualified buyers to jump through their hoops, the marketability, and therefore the value of the subject shares may be diminished. Finally, shareholder agreements that enhance marketability, such as the mandatory put option applicable to shares owned by an Employee Stock Ownership Plan, can actually augment value by reducing the marketability discounts that otherwise might be applicable to the shares.*

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

> *RR 59-60 is stating the obvious in the case of a descendent whose shares are subject to an option flowing to a corporation to (re)purchase descendant's shares at an agreed upon option price. That price becomes determinative of value for the* ***estate*** *that must tender the shares at that price. Alternatively, the same option is not considered by the ruling to be determinative of value for* ***gift tax purposes****. This discussion of restrictive agreements was expanded greatly in Sections 2701-2703 of the Tax Reform Act of 1986. The fundamental question being asked is this: "Would arms' length parties reasonably enter into an agreement like the subject restrictive agreement?" If so, the agreement may be determinative of fair market value. If not, then the agreement is not determinative of fair market value.*

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

> *Almost by definition, a restrictive shareholders' agreement is one of the "relevant factors" that must be considered in any valuation. The degree of consideration will, of course, relate to the facts and circumstances of each case. Qualitative consideration is virtually impossible. I developed the Quantitative Marketability Discount Model (QMDM) in the mid-1990s to provide an objective and quantitative method for considering the impact of restrictive agreements and many other factors on the value of illiquid minority interests.*

Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bonafide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2, 255, and Rev. Rul. 189, C.B. 1953-2, 294.

The IRS does not recognize agreements that hold a shareholder to one degree of freedom during his or her life, and another, more restrictive set of assumptions at death. Who can reasonably argue with that position?

Section 9. Effect on Other Documents

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

No comment.

Conclusion

In many ways, Revenue Ruling 59-60 is an extremely helpful document. In the often quoted Section 4, the ruling lays out the basic factors that must be considered in any gift or estate tax appraisal. If all appraisers would reasonably consider the Basic Eight factors in the context of every appraisal and would also subject their appraisal logic to the Critical Three factors of common sense, informed judgment and reasonableness, many appraisal disagreements would vanish.

Alternatively, the ruling is virtually silent at two critical points in the appraisal process. First, there is almost no guidance regarding the selection of appropriate valuation multiples, or capitalization rates. Interestingly, this is a major area of disagreement in contested appraisals. And second, there is no discussion of two major discounts that may be applicable and should be considered in every minority interest appraisal - the minority interest discount and the marketability discount. It should come as no surprise that the appropriateness of and extent of both of these discounts are often the subject of further disagreement in contested appraisals.

On balance, with a grounding in what I would call fundamental valuation analysis and repeated admonitions to consider all "relevant factors" in each valuation situation, Revenue Ruling 59-60 is a very sound document and provides important guidance for business appraisers in the 2020s, just like it did when issued in 1959. Every business appraiser, tax accountant, tax attorney and IRS agent dealing with business valuation issues should read this document occasionally.

About the Author

Z. Christopher Mercer is the Founder and Chairman of Mercer Capital, a national business valuation and financial advisory firm. Chris began his valuation career in the late 1970s. He has prepared, overseen, or contributed to hundreds of valuations for purposes related to tax, ESOPs, buy-sell agreements, and litigation, among others. In addition, he has served on the boards of directors of several private companies and one public company. He enjoys working with business owners to address ownership transition issues.

Chris has extensive experience in litigation engagements including statutory fair value cases, divorce, and numerous other matters where valuation issues are in question. He is also an expert in buy-sell agreement disputes.

He has the following professional designations:

- *FASA. Accredited Senior Appraiser, Fellow (The American Society of Appraisers)*
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Chris has written extensively on valuation-related topics and is a frequent speaker on business valuation issues for national professional associations and other business and professional groups.

Books authored by Chris include:

- *Business Valuation: An Integrated Theory, Third Edition* (John Wiley & Sons, Inc., 2021) with Travis W. Harms, CFA, CPA/ABV.
- *Unlocking Private Company Wealth: Proven Strategies and Tools for Managing Wealth in Your Private Business* (Peabody Publishing, 2014)
- *Buy-Sell Agreements for Closely Held and Family Business Owners: How to Know Your Agreement Will Work Without Triggering It* (Peabody Publishing, 2010)
- *Business Valuation: An Integrated Theory, Second Edition* (John Wiley & Sons, Inc., 2008) with Travis W. Harms, CFA, CPA/ABV
- *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* (Peabody Publishing, LP, 2007)
- *Valuing Shareholder Cash Flows: Quantifying Marketability Discounts* (Peabody Publishing, LP, 2005)
- *Valuing Enterprise and Shareholder Cash Flows: The Integrated Theory of Business Valuation* (Peabody Publishing, LP, 2004)
- *Quantifying Marketability Discounts* (Peabody Publishing, LP, 2001, & 1997)
- *Valuing Financial Institutions* (Business One Irwin, 1992)

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