VIEWPOINT ON VALUE

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Revenue Ruling 59-60

Tried-and-true guidance for valuing private business interests

Revenue Ruling 59-60 has been around for nearly 60 years. The IRS originally created this landmark publication to outline the approach, methods and factors to consider when valuing closely held businesses for gift and estate tax purposes. Today, it's often referenced in valuations prepared for other reasons, including divorce cases and shareholder disputes. With such a broad reach, it's critical that valuators and attorneys understand the issues this guidance covers.

How is fair market value defined?

Revenue Ruling 59-60 is perhaps best known for defining fair market value as "the price at which 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."

In other words, it's a transaction-based price that considers the perspectives of both hypothetical buyers and sellers. It assumes the subject business interest would be given adequate time to sell and both parties are well informed about the business and the market in which it operates.

What are the eight factors to consider?

This publication does much more than define fair market value. It admits that valuation is an inexact science, often resulting in "wide differences of opinion" about the value of a particular business interest. Therefore, appraisers need to take a customized approach that considers eight factors:

1. Nature and history of the subject company,
2. Outlook for the general economy and industry,
3. Book value and financial condition (from at least two years of balance sheets),
4. Earnings capacity (from at least five years of income statements),
5. Dividend-paying capacity (as opposed to dividends actually paid),
6. The value of goodwill and other intangible assets,

7. Previous arm's length transactions involving the subject company's stock and the size of the block of stock, and
8. Market prices paid in comparable transactions.

When evaluating these eight factors, valuators try to gauge a company's risk and financial condition, as well as estimate its future performance. For example, the first factor — nature and history of the subject company — demonstrates its historical levels of stability, growth and diversity (or lack thereof). These issues would be relevant to an investor if the subject company's future performance is expected to mirror its past performance.

What's hidden in the fine print?

In its discussion of these eight factors, Revenue Ruling 59-60 describes several other factors that may affect the value of a closely held business, such as:

Key people. When a company relies heavily on key people, its value may be reduced if they leave. The depressing effect is especially pronounced if the company hasn't implemented a succession plan or required key people to sign noncompete agreements. Life insurance policies and competent management can offset these risks, however.

Nonoperating assets. Investments, real estate and other assets that aren't essential to a company's normal business operations may require a higher or lower rate of return. So, valuators value them separately when appraising a business. They also adjust for income and expenses related to the nonoperating assets.

Nonrecurring income and expenses. An adjustment may be required to the company's historical earnings for income and expense items that aren't expected to happen again in the future. Examples include revenues and expenses from discontinued product lines or a one-time windfall from an insurance claim.

Weighing in on weights and averages

Business valuators consider lots of information and appraisal techniques before arriving at a final conclusion. Which information should be given the highest priority? When valuing a business that sells products or services, earnings and dividend-paying capacity generally take center stage. In contrast, asset values are usually more important when valuing investment or holding companies.

Revenue Ruling 59-60 cautions against the blind use of averages when valuing a business. If you apply the cost, market and income approaches, it's better to pick the technique that provides the most meaningful result than to simply average all three together. Averaging the results "excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts of the case except by mere chance."

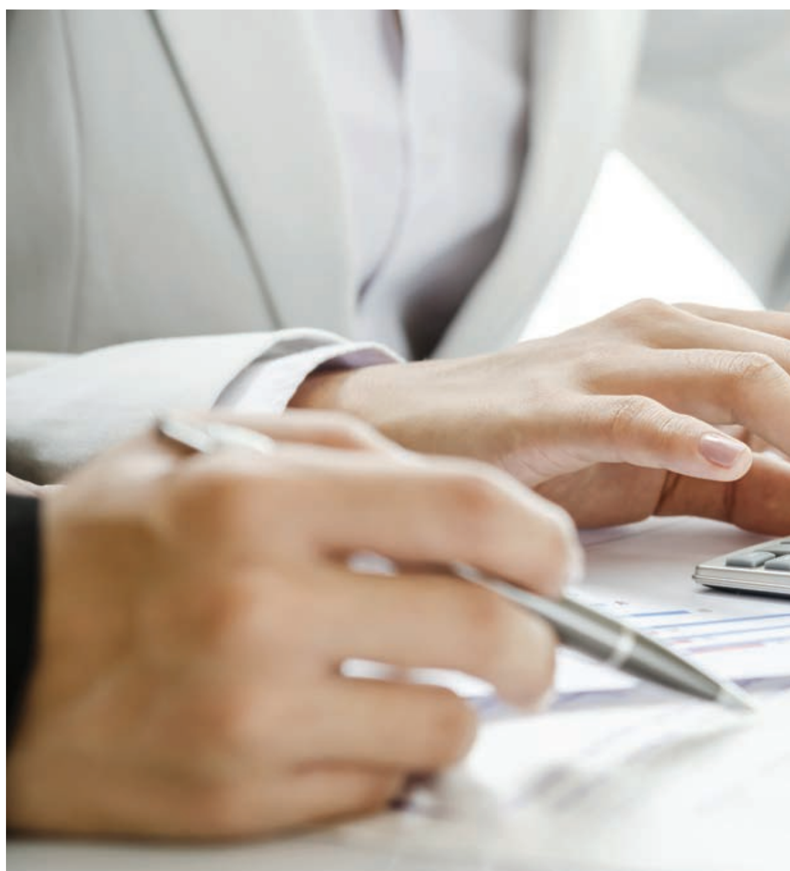
Revenue Ruling 59-60 doesn't prescribe a universal capitalization rate for every company. Instead, rates of return on earnings must be determined based on the nature of the business, risk, and stability or irregularity of earnings. Riskier businesses generally require higher capitalization rates, which results in lower values (and vice versa).

Have you read the ruling?

Almost every business valuation report cites Revenue Ruling 59-60 in some way. But it's surprising how few clients, attorneys and judges have read this landmark publication. Before you depose a valuator — or question one on the stand — review this guidance. It clearly outlines the valuation process and can be helpful in crafting meaningful questions about a valuator's qualifications and the approach taken in your case. ■

Spotlight on discount rates

As the business valuation discipline matures, judges, attorneys and other people who rely on appraisal conclusions are becoming more comfortable with the income approach. But how does a business's perceived risk translate into a reasonable discount rate? This is one of the most subjective — and contentious — aspects of valuing a business.



Breaking down the income approach

Under the income approach, value is a function of a company's expected economic benefits and its risk relative to other investment types. Valuators typically gauge expected economic benefits in terms of net cash flow. They measure risk by the company's cost of capital, which is the expected rate of return investors require to invest in the subject company.

Riskier businesses have lower values as a result of lower projected income, higher discount rates — or a combination of these. The two most common methods that fall under the income approach are the capitalization of earnings and discounted cash flow methods.

Discounting future cash flow

The key to both of these methods is converting expected cash flows (or other economic benefits) to present value. This requires the valuator to use a discount rate that reflects the time value of money and the degree of risk associated with an investment in the business. Put another way, the discount rate reflects the risk associated with achieving the expected cash flows.

When valuing a company's equity, valuators may estimate expected cash flows to equity investors and use the cost of equity as the discount rate. There are several methods for calculating the cost of equity, including the capital asset pricing model (CAPM) and the build-up method.

In other situations, a valuator may decide to value the company's invested capital — that is, its equity and interest-bearing debt. For example, what if a company's capital structure is different from those of other companies in the same industry or the company is under- or overleveraged? Under these scenarios, it may be more appropriate to use an invested capital technique to value the business and then subtract interest-bearing debt to arrive at the value of equity.

When valuing a company's invested capital, a valuator estimates future cash flows to both equity investors and lenders and then uses a blended cost of capital as the discount rate. A common example of a blended discount rate is

the weighted average cost of capital (WACC), which is the average of the subject company's cost of equity and cost of debt, weighted according to the relative percentages of each. Because the discount rate is based on the expected cost of new capital, valuators typically measure equity and debt by their market values, not their book values.

Again, the cost of equity is typically derived using the CAPM and the build-up method. And the cost of debt is usually based on the company's actual borrowing costs. The WACC formula also takes into account the company's effective tax rate to reflect the tax deductibility of interest expense.

Blending debt and equity

When valuing invested capital, determining the right "capital structure" — that is, the relative percentages of debt and equity — is key. The most appropriate structure is the mix of debt and equity likely to occur in the future.

When valuing a minority interest in a company, appraisers often use the company's actual capital structure. But when a controlling interest is being valued, it may be more appropriate to use an *optimal* capital structure, because a controlling owner has the power to change the company's capital structure.

There's a common misconception that the optimal capital structure means no debt at all. For most companies, the ideal capital structure involves a manageable amount of debt that allows owners to leverage their investment and boost their returns. Methods for determining a company's optimal capital structure include industry averages, capital structures of guideline companies and debt-to-equity criteria used by lenders.

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Using a proven approach

There's no one-size-fits-all method for computing discount rates. That's why experienced valuators use proven, systematic approaches based on objective market evidence to quantify reasonable discount rates. ■

Personal goodwill: It's not just for professional firms

Family courts struggle with the issue of goodwill. The majority view is that *business* goodwill is a marital asset that's subject to division but *personal* goodwill isn't. However, courts in a few states have ruled that all goodwill should be included in (or excluded from) the marital estate. South Carolina recently joined the majority in *Moore v. Moore*. Here's more on this important ruling.

Family court adopts 90/10 split

In 2001, the wife opened a retail store that sold high-end light fixtures and home décor. In 2005, the husband helped it transition from a brick-and-mortar store to an online retailer. By 2011, about 80% of the company's orders were generated by its website.

The wife's valuator estimated that the company was worth approximately $1.2 million as

of June 30, 2011, and warranted a 20% discount for lack of marketability. The expert allocated about $350,000 to net tangible value and $850,000 to goodwill. He attributed 20% to 25% of the overall goodwill value to personal goodwill, which is inextricably linked to the wife and can't be transferred to a third party.

The husband's expert valued the business at approximately $2.96 million as of June 30, 2012, a year after the divorce filing. He took no discount for lack of marketability and attributed only 10% of the goodwill value to the wife personally. The family court sided with the husband's expert.

Both sides appeal

On appeal, the wife argued that all of the goodwill was personal and should be *excluded* from the marital estate. Conversely, the husband believed all of the goodwill belonged to the business and should be *included* in the marital estate.

The central issue is: To what extent is business goodwill a marital asset? The Supreme Court of South Carolina ruled that business goodwill is a marital asset that should be distinguished from personal goodwill and divvied up in divorce cases.

A secondary issue that emerges is: Can retailers have personal goodwill? Traditionally, personal goodwill has been associated with service firms that attract clients based on the skills, reputation and personal relationships of individual owners. Retailers generally don't add value to their products. But there are exceptions to the rule. In this case, the court decided that the wife had specialized training, experience, dedication and artistic abilities that added value to the business. And the wife hadn't signed a noncompete agreement, so she could leave and take customers with her at any time. Accordingly, the appeals court increased the percentage of personal goodwill from 10% to 20%.

In addition, it reduced the value of the business from $2.96 million (based on the testimony of the husband's expert) to $1.2 million (based on the testimony of the wife's expert). The earlier appraisal date was deemed more appropriate under state law and the facts of the case. But the appellate court upheld the lower court decision to disallow a discount for lack of marketability.

Guidance for all

This court opinion provides a detailed explanation of how to allocate value between personal and business goodwill. In doing so, it advises family courts to consider one simple question: Can the business generate revenue from continued patronage without the current owner's participation? If not, personal goodwill may exist. This guiding principle can be useful in all states that have adopted the majority view on goodwill. ■

Using a third expert to bridge the gap

When each side to a legal dispute hires its own business valuator, the two experts are unlikely to come up with *exactly* the same conclusion — even if they're both credentialed and use proven valuation techniques. For this reason, it sometimes makes sense to hire another valuator to identify and reconcile key differences. A third expert can be particularly helpful when the gap between expert opinions is wide and the underlying reasons are unclear.

Keep costs down

Parties to a lawsuit may hesitate to hire a third expert, simply because they don't want to incur more professional fees. But the use of a third expert can mean the difference between settling amicably and engaging in a drawn-out courtroom battle. If you avoid going to court, you'll save thousands of dollars — and, in effect, the expert will pay for him- or herself.

It's also important to understand that a third expert is almost always less expensive than hiring the first round of experts. One reason is that the parties often share the cost of obtaining a third opinion. What's more, third experts can leverage off the original reports and any assumptions that the parties can stipulate to in advance. In many cases, these valuators issue less expensive, abbreviated "letter" reports.

Define the parameters upfront

The trick to minimizing the costs of using a third expert is to work out the details up front with the opposing side, including:

- Who will select the expert?
- Who will pay the expert's fees?
- Which documents and workpapers will the expert be allowed to use?
- Should the third expert perform other valuation procedures, such as interviewing management and conducting site visits?
- What type of report will the expert issue?

Also give some forethought to the minimum qualifications an expert should possess, including professional credentials, years of experience and industry experience.

Decide how to use the report

Another important detail to iron out *before* the third expert finishes his or her report is how the parties will use the conclusion. For example, you might decide to average all three conclusions together. Or you might agree to disregard the other conclusions and use the third valuation as the final value.

Any of these options are usually preferable to simply "splitting the difference" between two reports, especially if one side perceives the opposing expert as unqualified or biased. A third expert can provide fresh perspectives, reduce animosity and help the judge make a better-informed decision if you're unable to settle out of court. ■

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