Sometimes Less Is More: A Guide To Valuing A Closely Held Farming Corporation For Estate And Gift Tax Purposes

INTRODUCTION

While death and taxes may be inevitable, the amount of taxes incurred at death can be reduced by selecting a favorable method for valuing assets. Minimizing gift and estate tax liability may help keep the family farm in the family.

This comment deals specifically with valuing a closely held farming operation for the purpose of determining estate and gift taxes attributable to the transfer of interests in that business. Internal Revenue Service Revenue Ruling 59-60[1], which governs this type of value, proposes a fair market value approach. Valuation, however, is not limited to the fair market value of an asset.[2]

---

[1] While the Internal Revenue Code frequently refers to the value of property, Congress never codified a definition nor an appropriate valuation method. In 1959, the Internal Revenue Service issued Rev. Rul. 59-60, 1959-1 C.B. 237, to explain, in general terms the factors it would require to be taken into account in determining the value of assets. This Ruling did not prescribe specific valuation methods.

[2] "Value" has several different meanings, including the following:

A. Going Concern Value - This most nebulous term merely refers to the value of a company as a going concern, its inherent value of already being in existence. Revenue Ruling 65-193 recognized the ability to value these intangible elements of a business and ruled that they fall under Revenue Ruling 59-60.

B. Liquidation Value - Usually calculated to establish a lower limit for the value of the company, Liquidation Value presumes that the business will cease operations and its assets will be sold. This may be ordered over a reasonable period of time or forced where the assets are sold quickly, i.e. an auction.

C. Investment Value - This value is specific to a certain owner or prospective owner. It takes into account a particular person's knowledge, experience, financial position and needs.

D. Fair Value - Fair Value, which is not the same as Fair Market Value, is judicially determined to protect minority shareholders in business combinations. Some state statutes have established formulas for calculating the Fair Value of a closely held corporation.

E. Book Value - Actually an accounting term, as opposed to a type of "value", Book

I. What Is Unique To Farming Operations?

Farmers face some unique opportunities and hazards in planning for the succession of business interests from one generation to another. The valuing of an agricultural corporation is often complicated by the fact that it contains a large amount of land and other assets, including crops and equipment. These assets, specifically land, are used for a unique purpose which does not lend itself to easy valuation. Appraising that land as part of a farming operation requires special considerations.[3] For instance, the value of land used only for farming is usually less than if that same piece of land were used for development or sold on the open market.

Farming corporations are often family-owned enterprises. The only available market for shares of stock in the corporation is among other family members. An individual outside the family would be willing to pay considerably less for the shares than a family member because of the lack of ability to resell the investment.[4] As the stock is transferred to younger generations, a greater number of people hold individually smaller interests in the corporation. As the size of the interests diminish, the lack of control of any one individual in the corporation affects its value.[5]

The decision regarding which valuation method is most appropriate

---

Value refers to the excess assets over liabilities of a business. In a corporation, this equals the Stockholders' Equity section of the balance sheet. Book Value is rarely, if ever, considered the "value" of a company because of its susceptibility to manipulation.

F. Fair Market Value - Under Revenue Ruling 59-60, Fair Market Value of a company is the amount 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 the relevant facts. Even in transfers among related parties, Fair Market Value assumes an arm's length transaction.

[3] I.R.C. § 2032A (CCH 1993) The real property may be valued based on its use in farming if:

1. fifty percent or more of the adjusted value of the gross estate consists of the qualifying real property, or

2. twenty-five percent of the adjusted value of the gross estate consists of farming land and the family has materially participated in the operation of that farm for five of the last eight years.

[4] Discount for lack of marketability - Revenue Ruling 59-60 recognizes that the value of the assets of a business should be discounted to reflect the difficulty in finding a market for an interest in that business.

[5] Minority discounts - Revenue Ruling 59-60 recognizes that the value of the assets of a business can be discounted to reflect the lack of control a minority shareholder would have in the management of those assets.

depends upon many factors. Consider the following scenario:

Prior to his death, Mr. Albert Nelson, a widower, operated Nelson Farming Company, a California corporation. Albert acted as President and General Manager of the Company. Shares of stock in the Company are held as follows:

	Shares	Percent
Albert Nelson	1,680	31
Barbara Nelson Bypass Trust	1,990	36
Barbara Nelson Q-Tip Trust	1,830	33
Total	5,500	100

When Albert's wife, Barbara Nelson, died several years ago, her estate, including her one-half interest in community property held by her and Albert, was distributed to the Barbara Nelson Bypass Trust[6] and the Barbara Nelson Q-Tip Trust.[7] Albert acted as trustee of both trusts.[8] He was also the lifetime income beneficiary[9] in the trusts, with trust principal[10] going to Albert's and Barbara's three sons, Chester, Dan and Frank, at Albert's death.

Nelson Farming Company operates a farm consisting of livestock and crops. The Company owns the equipment used in these operations. The land and the livestock housing facilities are owned by Albert's es-

[6] A Bypass Trust is a testamentary trust which transfers assets from the estate into an irrevocable trust in order to avoid being included in the surviving spouse's taxable estate. This trust is most often used to take advantage of the transferor's $600,000 estate tax exclusion.

[7] Q-Tip stands for qualified terminable interest property. A Q-Tip trust is established by one spouse to transfer such property to a person, usually a surviving spouse, for the transferee's lifetime. The executor makes an election to transfer to a trust for the benefit of the survivor so as to maximize the marital deduction and defer estate taxes until the survivor's death. In order to avoid estate tax at the transferor's death, the survivor must be entitled to all of the income from the interest, payable at least annually, for life. Also, no one, including the survivor, may have power of appointment for any part of the corpus of the trust, during the lifetime of the survivor. The interest created is known as qualified terminable income for life. I.R.C. §§ 2056(b)(7) and 2523(f) (CCH 1993).

[8] The trustee holds legal title to the property of a trust for the purpose of protecting or conserving it for the benefit of the ultimate beneficiaries under the rules of courts of equity. Trustees are held to particularly high standards of fiduciary duties. Treas. Reg. § 307.77014(a) (1955).

[9] A lifetime income beneficiary receives the income of the trust for life with the corpus (principal) passing to a remainderman on the death of the income beneficiary.

[10] The trust principal, or corpus, as it is sometimes called, is merely the property of the trust other than income.

tate, as well as the two trusts, to be leased to the Company, typically for terms no longer than five years.[11] Chester is the only of Albert's three sons who is active in the family business.

In the five years from 1986 through 1990, the Company's financial records reflected modest growth in production and consistent profitability:

Year	Net Income	Total Assets
1986	46,000	531,000
1987	50,000	524,000
1988	64,000	538,000
1989	43,000	594,000
1990	39,000	625,000

During those five years the Company experienced a growth in gross income as follows:

Year	Livestock	Crops
1986	406,000	200,000
1987	459,000	228,000
1988	407,000	387,000
1989	389,000	433,000
1990	410,000	306,000

The markets for both the livestock and the crops experienced favorable conditions, demand and prices during these five years.

After Albert's death in May, 1991, several factors contributed to a decline in the profitability of the Company. Crop production slowed as a result of poor weather conditions and a disease in the trees which caused the roots to weaken and the trees to fall over. This disease necessitated replacement of the trees. In October, 1991, the Company was notified that one of its major livestock processing contractors was cancelling its contract because of poor market conditions. In November, 1991, the largest processing plant in the region announced it was closing and cancelling all contracts with ranchers. This is expected to reduce production of livestock by as much as thirty percent.

[11] As strange as this arrangement may sound, it is not all that uncommon in family-owned and family-controlled farming operations. It can provide flexibility in meeting the retirement needs of the parents. It can create additional options for dealing fairly with off-farm heirs without forcing their involvement in the farming operation. It also reduces the investment needed by the on-farm heirs in gaining control of the operating side of the business. NEIL E. HARL, FARM ESTATE PLANNING, ANNOTATED MATERIALS 8-1 (1991).

At his date of death, Albert's estate value, not including the Company and the trusts, was $1,400,000.

II. Valuation Date

Chester Nelson, as executor of Albert's estate, needs advice on valuing the Company and the trusts for Albert's federal estate tax return. Under Internal Revenue Code §2001(a), the federal government imposes a tax upon the transfer of the "taxable estate" of every decedent.[12] Albert's taxable estate, including the Company and the Q-Tip trust (which owns stock in the Company), is based on the value of the property in which he owned a beneficial interest at his death.[13]

In determining the most accurate, and the most beneficial, valuation method, the date of the appraisal is important. Events which take place after the valuation date should have no impact on it.[14] Generally, an estate is valued at the decedent's date of death.[15] However, an election can be made to use an alternate valuation date of up to six months after the date of death.[16] In the case of Nelson Farming Company, at Albert's death in May, the Company is in the midst of a continued period of modest, sustained growth. However, by November, it is clear that both the Company's crops and livestock will be experiencing significant downturns for the foreseeable future. If the estate elects, under §2032(d), an alternate valuation date six months after Albert's date of death, the value of the Company's stock can take into account these subsequent developments.

III. Valuation Methods

Nelson Farming Company is a closely held corporation.[17] The Internal Revenue Service specifically addressed the valuation of this type of

---

[12] This tax is based on applying a statutory tax rate to the decedent's taxable estate. The taxable estate is the value of all property to the extent of the decedent's interest therein (gross estate), less allowable exemptions and deductions. Treas. Reg. § 20.0-1(a)(2)(3) (as amended in 1980).

[13] I.R.C. § 2033 (CCH 1993).

[14] Ithaca Trust Co. v. U.S., 279 U.S. 151, 157 (1929).

[15] *Id.*

[16] I.R.C. § 2032(d) (CCH 1993) allows for the estate to elect an alternate valuation date no later than six months following the date of death.

[17] "Closely held corporation" is a colloquialism for corporation, the stock of which is owned by a relatively small group of shareholders, often family members. These corporations are often subject to special scrutiny and statutory control because of the potential for tax abuse. This should not be confused with a statutory close corporation as defined by I.R.C. §§ 465(a)(1)(B) and 542(a)(2) (CCH 1993) which deals with issues

entity in 1959.[18] It listed eight factors which must be considered in determining the stock's value:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earning capacity of the company.
5. The dividend-paying capacity.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block to be valued.
8. 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.[19]

The ruling left ample room for professional judgment in determining the value and in determining the best method. The various approaches used have been established through industry practice and court approval.[20]

To analyze the various methods and determine the best to use for Nelson Farming Company, we will look at the valuation process in three tiers: valuation concepts, valuation approaches and valuation methods. There are three general concepts in which to view the valuation process: income, market and cost.

A. *Income Concept*

The income concept comes closest to the basic valuation premise of Revenue Ruling 59-60.[21] Under the income concept, the value of a

---

not relevant here.

[18] Rev. Rul. 59-60, 1959-1 C.B. 237.

[19] Rev. Rul. 59-60, 1959-1 C.B. 237, while considered by many professionals as the most significant guidance from the government on valuing closely-held stock, addressed the issue only in general terms. It did not set out a specific formula required for valuing the stock. To the contrary, it emphatically stated that the value is a question of fact and, as such, can not be determined through the use of a single formula in all occasions.

[20] The IRS has, in one instance, actually mandated a specific method of valuation. In valuing intangible assets, the IRS established, in Rev. Rul. 68-609, 1968-2 C.B. 327, the "Excess Earnings" Method. This method will be described later in this comment.

[21] The term "income" does not really refer to income according to generally accepted accounting principles, but actually, to the future benefits accruing to the owner.

company represents an estimate of its future ownership benefits adjusted to present value using a rate suitable for the risks associated with realizing those benefits.[22]

There are two approaches to valuations under the income concept. Both approaches rely on estimating a company's future benefits and operating results in order to estimate value.[23] Under the capitalized returns approach, current earnings (or cash flows)[24] are divided by a capitalization rate to determine the value of the company. This approach assumes that current operations are reasonably expected to continue.[25]

If future earnings or cash flows can be reasonably estimated, but are expected to differ substantially from current or historical performance, the discounted future returns approach would be more appropriate. This approach discounts future earnings from forecasted operations to present value.[26]

B. Market Concept

The market concept assumes that the value can be determined by looking at the market. It involves thorough analysis of comparative data, such as financial ratios, from companies recently sold on an open market to appraise a similar corporation.[27] This concept can be difficult to apply because of the challenge and time involved in finding and evaluating a comparable company.[28]

---

[22] JAY E. FISHMAN, GUIDE TO BUSINESS VALUATIONS, 2-5 (Practitioner's Publishing Company, July 1992).

[23] *Id.* at 2-7.

[24] Methods of valuation under the income approach can be based on different definitions of "income." The valuation can use net earnings, gross cash flows or net cash flows as income to be discounted. Which method to use will depend on the type of entity and the industry in which it operates as well as the purpose of the valuation. In most closely held corporations, including farming, net cash flows is most useful because the owners will be interested in the cash that they will be able to withdraw from the corporation in the future. JOSEPH D. VINSO, VALUATION OF CLOSELY HELD BUSINESS INTERESTS 44 (California Society of Certified Public Accountants, 1990).

[25] FISHMAN, *supra* note 22, at 5-2.

[26] *Id.* at 5-5.

[27] *Id.* at 2-5. In most cases the only data available related to companies recently sold will be for corporations sold on a public market. This makes this concept difficult to use for closely-held corporations. Some courts in California have held that valuing a corporation by obtaining a price-earnings ratio of one or more public companies and multiplying that number to a closely-held company's earnings is inappropriate, *In re Lotz*, 120 Cal.App.3d 379 (1983) and *In re Hewitson*, 142 Cal.App.3d 874 (1983).

[28] FISHMAN, *supra* note 22, at 6-3. The best use for the market concept in valuing closely held farming corporations is as a "sanity" check after arriving at a tentative

C. Cost Concept

The cost concept[29] is most often used when appraising components of a corporation. It proposes that the value of a company is only represented by the underlying worth of the assets of the entity. This concept generally assumes that the company will not continue as a going concern.[30]

Under the net asset method, the company's assets and liabilities are restated from cost to fair market value, in order to calculate the value of the company's equity.[31] The liquidation method estimates the net proceeds from selling or otherwise disposing of all company assets, and discounts those proceeds to present value.[32] Both methods give no weight to the company's expected future earning power.

The cost concept may also include valuing intangible assets as well. The most widely accepted method for valuing intangible assets, namely goodwill, is the excess earnings method.[33] Relatively simple to calculate, it begins by determining a reasonable rate of return for the company.[34] This rate is compared to the company's historical earnings or cash flow. Any return above the amount expected is considered to have arisen from intangible assets. These excess earnings are capitalized to arrive at the value of the intangible assets. The value of the corporation is deemed to be the sum of the values of the tangible and intangible assets.[35]

This method is often ideal for small closely held corporations because of its simplicity. It works best when valuing professional corporations whose primary asset is often intangible — its reputation, or goodwill,

---

value using the other methods. It may be used as support for a value determined under another concept.

[29] Literature often refers to this concept as a cost approach. A more appropriate term would be asset-based concept. The approaches and methods included in this concept all emphasize the value of the assets of a company. They do not necessarily look only at the cost of those assets.

[30] FISHMAN, *supra* note 22, at 2-5.

[31] *Id.* at 7-1.

[32] *Id.* at 7-2. This method is most appropriate for companies who are already in a liquidation mode and, for instance, have or are about to file chapter 7 bankruptcy.

[33] Also known as the "formula method" or the "treasury method." Originally established by the U.S. Treasury Department in 1920 (Appeals and Review Memorandum 34, ARM 34), it was recognized by the IRS in Rev. Rul. 68-609, 1968-1 C.B. 327.

[34] This reasonable rate of return is the rate of return required to produce the necessary future benefits to the owners of the company. This rate includes factors to recognize the risks associated with the company and the industry as well as the experience of the company's management.

[35] Rev. Rul. 68-609, *supra* note 33.

and client list.[36]

IV. Choosing A Method

No authority exists which mandates any one method for any specific type of valuation. Income-based approaches tend to be more reliable for companies with a consistent, predictable customer base whose future or normal earnings can be reliably estimated. A company whose assets consist primarily of production assets is most likely best valued through the income concept as well.[37] Also, if key personnel will be retained or can be easily replaced, the income concept is probably best. If a company has no earnings history or if its customer base and earnings are inconsistent and difficult to estimate, the asset-based concept is more ideal.

In valuing a closely held corporation, certain special factors should be taken into consideration. Most agricultural corporations are held by owner-managers. Their value is based on the salaries, benefits and cash flows available to the owners. They are typically not held to accumulate investment wealth. As a result, earnings are often understated in order to pass wealth out to the owners and to avoid taxable income. Because the owners typically manage the business, the experience and knowledge of the transferee, the individual who will receive the stock, is crucial to the value of the company. Comparing the company with similar corporations for which a value has already been established (for instance, through a sale) can be useful as a "sanity" check, but is most likely difficult to find.

Nelson Farming Company is not in a unique position. Determining which valuation approach to use will have an enormous impact on the outcome of the valuation.[38] Choosing the wrong method could force the estate to sell the business in order to pay its estate taxes. Chester's livelihood depends upon the farm being transferred to Albert's heirs and

---

[36] FISHMAN, *supra* note 22, at 7-21.

[37] If the assets' only purpose is the production of income, then their value is more realistically based on the future benefits (income) they will produce.

[38] Albert, like many owners of farming companies, is leaving an estate with modest liquid assets but, potentially, substantial value. As with most farmers, just like most small business owners in general, the concept of an estate tax is unfamiliar territory. Albert's heirs will most likely be unprepared to pay an estate tax. Estate tax rates are high compared to the income tax rates most people are familiar with. The net value of an estate over $600,000 is taxed at a rate table beginning at 18 percent but quickly jumping to as high 65 percent. An estate with a net value of $1,000,000 above the $600,000 exemption is taxed at a rate of 41 percent. These taxes can easily be in the hundreds of thousands of dollars. I.R.C. § 2001(c) (CCH 1993).

continuing as a going concern. The Company is small enough that, under normal circumstances, the Excess Earnings Method would be ideal. That method uses historical earnings to value intangible assets. However, due to the recent and substantial changes to the Company's earning power, this method would most likely overstate the future benefits which will accrue to the owners.

A. *Excess Earnings Method*

If Albert's estate chose to simply rely on the simplest method without taking advantage of minority and lack of marketability discounts, Chester and his brothers would have no choice but to sell the business. To avoid this result, consideration should be given before applying the commonly used excess earnings method just because of its simplicity. Through historical earnings this method determines a value for the intangible assets of the company, such as goodwill. This is added to the value of the tangible assets to arrive at a value for the entire business.[39] While widely favored for small businesses, this method has been criticized as arbitrary and unrealistic.[40]

The Excess Earnings Method calculates the value of Nelson Farming Company to be $510,000.[41] Albert's estate owns 3,510 of the outstanding 5,500 shares of the Company. His estate would include a value of $325,482 in his taxable estate. This creates an estate tax of

[39] Rev. Rul. 68-609, *supra* note 33. An expected rate of return is determined to calculate the amount an owner would require as a return on his or her investment in the business. Historical earnings which exceed this rate are considered excess earnings. By applying a capitalization rate to those excess earnings, the intangible assets of the business can be valued.

[40] Internal Revenue Service, *IRS Appellate Conferee Valuation Training Program*, (Chicago: Commerce Clearing House, 1978) pp. 82-86. "ARM 34 has been applied indiscriminately by tax practitioners and by members of the Internal Revenue Service since it was published. . . ARM 34 was published in 1920, but since that time it has continuously appeared in the annals of tax valuation and resulted in many improper appraisals. . . .

The basic defect is apparent; the rates of return which are applied to tangibles and to intangibles are completely arbitrary and have no foundation in fact."

[41] This is calculated as follows:

$459,350.[42] As is common in the agricultural industry, Albert's estate is not cash rich. An estate tax of this size could force the Nelson children to liquidate assets in order to pay the tax timely. Without other liquid assets, the estate may have no choice but to sell farm land or equipment.

A more advantageous valuation method for Nelson Farming Company would be the Discounted Future Cash Flows Method because it takes into account the future profitability of the Company.[43] The Company can reasonably forecast its earnings based on its remaining pro-

---

Year	Actual Earnings	Expected Earnings	Excess Earnings
1986	$ 18,850	$ 12,500	$ 6,350
1987	66,000	15,500	50,500
1988	64,000	17,500	46,500
1989	48,500	20,500	28,000
1990	45,000	22,450	22,550
Total	$242,350	$ 86,750	$153,900

Average Excess Earnings	30,780
Divided By Excess Capitalization Rate	22.8%
Value of Intangible Assets	135,000
Value of Tangible Assets	375,000
Total Value	$510,000

The expected rate of return has been determined to be 7 percent. This rate is based on the level of risk associated with the industry of the business. The capitalization rate on excess earnings is judgmentally determined, as explained earlier, by taking into account market conditions and management experience. The value of tangible assets is based on book value.

[42] This is calculated as follows:

Value of Nelson Farming Shares:	325,482
Value of All Other Assets:	1,400,000
Taxable Estate	1,725,482
Tentative Tax	657,250
Less: Uniform Credit	(192,800)
Estate Tax	464,450

[43] Discounted future cash flows is based solely on future net cash flow. Nelson Farming Company is expecting a steep drop in its revenue and earnings ability. Most small businesses rely on cash flow to survive. They are not investment driven as public companies would be. Also, because the Company will need to purchase new trees (a fixed asset rather than an expense) and will most likely be forced to make improvements to the livestock facility to convert it to another use, its cash flow will be substantially less than its earnings in the future.

ductive crops and the size of its few remaining livestock contracts.[44] This method will not, however, take into account the value of the facilities as well as the value of the Company's past earnings ability. Both of these factors must be weighed in determining the value of the corporation.[45]

In order to take into account both future expected cash flow and historical earnings, a weighted average of two methods would be most appropriate. By appraising the Company using the discounted future cash flows and also including an allowance for book value, the value of the assets, as well as its expected downturn, can be recognized.[46]

B. *Discounted Future Cash Flows*

1. Future Cash Flows

The first step in valuing the Company under the Discounted Future Cash Flows (DFCF) is to establish a forecast for the Company. This process is best performed by the owners and managers of the Company.[47] Most commonly for a period of between five and ten years, the forecast should estimate net income based on factors and conditions known at the date of valuation.[48]

To arrive at projected cash flows, non-cash transactions, such as depreciation, should be disregarded. Fixed asset acquisitions, debt payments and other cash transactions which normally do not affect profit or loss should be taken into account.[49] Non-operating transactions, such

---

[44] The livestock contracts are created in advance of raising the animals. Based on the quantity of the contracts, the Company knows how many animals to raise.

[45] Charles F. Hubbs & Co. v. Commissioner, 8 T.C.M. (CCH) 903, 917 (1949). See also Maltine Co. v. Commisioner, 5 T.C. 1265, 1271 (1945).

[46] Rev. Rul. 59-60, *supra* note 4. Various factors can be weighted. It does not prescribe a certain mathematical formula for assigning weights but it does require that both the earning capacity of the company along with its book value must be taken into account. In In re Milton Feldmar, 56 T.C.M. (CCH) 118 (1988), the tax court, in determining the value of the estate, weighted, among other factors, the discounted future earnings and the book value of stock of a closely held corporation.

[47] Although they have a vested interest in the outcome, they are almost always the most qualified to estimate the future performance of the Company. It is the job of the appraiser to review the forecast for reasonableness to avoid the perception of self-interest.

[48] GRANGER, CLIVE W. J., FORECASTING IN BUSINESS AND ECONOMICS (Academic Press 1980). Five years are used because it is generally accepted that it is usually possible to forecast five years ahead with some degree of accuracy under normal conditions and anticipated influences. Beyond five years, the accuracy of a forecast is typically thought to be much less.

[49] These transactions reduce cash but only affect the balance sheet of a company, not

as officers' compensation, should be removed or adjusted.[50]

Net cash flow for Nelson Farming Company, as adjusted for non-operating transactions and asset and debt transactions, is forecasted as follows[51]:

Year	Net Cash Flow
Year 1	(7,000)
Year 2	21,000
Year 3	(19,000)
Year 4	18,000
Year 5	22,000

2. Discount Rate

A discount rate represents the total expected rate of return that a buyer would demand on the purchase price of an ownership interest given the level of risk inherent in that investment.[52] The most common method used to determine the appropriate discount rate is to start with a risk free rate of return and to add to it, through judgmental analysis, based on the risk involved in the industry and the company.[53] Based on

net income.

[50] Closely held businesses will often include expenses that are unique to the owners that are not a part of the operations of the business. For instance, many family-owned farms include the residence of the owners. While this may in some cases be necessary for the management of the farm, some allowance should be made to remove debt payments for the personal assets that would remain with the owner or transferor. Tax planning in small businesses will often involve paying as much as reasonably possible to the owners as officer compensation. This expense should be adjusted to eliminate the tax planning consequence of the expense. Under Rev. Rul. 59-60, *supra* note 4, the value should represent an arm's length transaction and the amounts paid as compensation expense should represent what would be paid to an unrelated manager. On the income side, interest income may include income from investments which are held in the corporation that are not directly related to the operation of the business. These amounts should be removed as well. VINSO, *supra* note 23, at 45.

[51] The fluctuations between positive and negative cash flow are a result of expected income from remaining terms of the livestock contracts and expected fixed asset costs for trees and gradual renovation of the livestock facility.

[52] Unlike a capitalization rate (usually applied to historical earnings or cash flows), the discount rate is used to derive present value factors which are used to discount a future benefit stream. FISHMAN, *supra* note 22, at 5-5.

[53] The risk free rate is typically the maturity rate for long-term treasury bills. This represents the rate of return an investor would receive in the most risk-free investment available. An amount would be added to this representing the additional rate of return an investor in stock of companies in this industry would expect. This can be difficult to obtain for smaller closely held businesses. Financial statistic editions, such as Dun and

this approach the discount rate for Nelson Farming Company has been determined to be 15.78 percent.

3. Calculating the Value

This discount rate is used to obtain a factor to apply to the projected cash flow to calculate the present value of those cash flows. In arriving at the present value of the projected cash flows, an amount should be included which estimates the present value of the income stream continuing in perpetuity. Based on this method, the value of Nelson Farming Company would be $126,000.[54]

C. Book Value

Book value is not appropriate as the sole determining factor in valuing an ongoing business. The purpose for it in a weighted average approach helps to ensure that the determined value recognizes the underlying value of the tangible assets.[55]

The balance sheet equity section is a reasonable estimate of the book value of the assets of Nelson Farming Company.[56] In applying this method to a farming operation, the key difference between book value

---

Bradstreet or Robert Morris & Associates, provide industry rates of return broken down by size of the company. Finally, an amount is added which represents the judgmental analysis of the risk associated with the specific company being valued. If a company is less stable, or has less experienced management, than other companies in the industry, an individual would not invest in that company unless he or she expects to receive a higher rate of return on his investment than he could receive in a more stable company in that industry. Generally, the IRS and the courts will accept discount rates between 15 and 30 percent.

[54] This is calculated as follows:

Year	Cash Flow	Present Value
Year 1	(7,000)	(5,899)
Year 2	21,000	15,699
Year 3	(19,000)	(12,096)
Year 4	18,000	10,310
Year 5	22,000	10,596
		18,610
Present Value in Perpetuity		107,390
Total Value		126,000

[55] BUSINESS VALUATION FOR ACCOUNTANTS - BROKERS - APPRAISERS, E-14 (Institute of Business Appraisers 1990).

[56] Remember, the main purpose for including this method in the valuation is to recognize the past performance of the corporation, because the future returns do not represent the past profitability of the Company.

and balance sheet cost will be land. Most other assets in a farming business have little marketable value above cost.[57] In the case of the Company, the land is held outside the corporation. At the date of valuation the Company's equity, including interim earnings, was $365,000.

D. *Weighted Average*

Using an even weighing between the two methods, the Company's value at the date of valuation would be as follows:

	Value	Weight	Adjusted Value
Book Value	$365,000	50%	182,500
DFCF	126,000	50%	63,000
Adjusted Value			245,500

V. Discounts

A. *Minority Discount*

It is important at this point to remember the purpose of the valuation. The intent is to appraise Albert's interest in the corporation, not necessarily the corporation itself. Arguably, the most controversial aspect of the valuation process is determining appropriate discount and/or premiums to apply to the company's value to arrive at the value of an interest in that corporation.[58]

The simplest method of determining the applicable discount is to use a direct comparison with sales of other minority interests. This approach eliminates the need to value the company as a whole and then value a smaller interest in it. Prior arm's length transactions involving minority interests in the same company provide strong evidence. These transactions must be analyzed carefully, however, to ensure that they were truly arm's length transactions.[59] Another source for comparative data is sales in minority interests of comparable publicly traded

[57] If not fully depreciated, most equipment used in a farming business can be sold for little above cost.

[58] A discount is generally deducted to give proper weight to the difficulties for a minority stockholder to either influence management, or acquire control, or bring about a liquidation to convert the asset value into cash. Rev. Rul. 59-60, *supra* note 4, and Estate of Arthur F. Little Jr. v. Commissioner, 43 T.C.M. (CCH) 327 (1982). The controversy arises over when the discount is applicable and how much it should be.

[59] Shannon P. Pratt, Valuing A Business, 400-401 (Second Edition, Business One Irwin 1989).

companies.[60]

Not widely used, the "Bottom-Up" approach is gaining acceptance. Supporters of this method believe that there is no reason to value the company as a whole because the expectations of a minority shareholder are not the same as that of the controlling owner of a corporation.[61] A minority interest holder will realize a return on his investment only through dividends or proceeds from a sale of the interest. This method begins by projecting the expected future dividend payout[62] and the amount realizable on the sale of the shares. These two amounts are then discounted using a discount rate which reflects the risk that they will actually be paid.[63]

The most common approach to determining the discount for minority interest is to value the company as a whole, pro-rate that amount to a per share basis and then determine a discount to apply to the minority interest holder's shares.[64] This is a qualitative issue, rather than a quantitative one.[65] Courts have generally been more generous than the IRS in granting minority discounts.[66] In family-owned corporations, the IRS required that all family-owned shares be aggregated and if the

---

[60] In Estate of Mark S. Gallo v. Commissioner, 50 T.C.M. (CCH) 470 (1985), both the IRS appraisers and the appraisers for the Gallo's were valuing the decedent's minority interest by comparing it with stocks of comparative publicly traded companies.

[61] Joel Adlestein, Real World Challenges in Valuing Stock Minority Shareholdings in Private Corporations, Remarks at the Fourth Annual ASA Advanced Business Valuation Seminar, New Orleans, (Nov. 7-8, 1985).

[62] This should be the expected dividend payout rather than the dividend paying capacity of the company. A minority interest holder by definition will not have the ability to declare dividends whenever the company can afford it. PRATT, *supra* note 59, at 403.

[63] *Id.* at 402.

[64] *Id.* at 397.

[65] The courts and the IRS look to the relative authority of the shareholder rather than only the number of shares owned. Factors considered include the ability to appoint directors or hire management, the ability to set compensation, the authority to set policy or business course, make decisions regarding acquiring or liquidating assets, awarding contracts, and the ability to declare and pay out dividends. Northern Trust Co. v. Commissioner, 87 T.C. 349, 388 (1986).

[66] The tax court allowed a 33.33 percent discount for a minority interest in a closely-held newspaper company. Harry Stoddard v. Commissioner, 34 T.C.M. (CCH) 888, 898 (1975). In another case, the tax court allowed a 55 percent discount from the fair market value of the underlying investment portfolio in valuing a minority interest in a closely held investment company. Edwin G. Gallun v. Commissioner, 33 T.C.M. (CCH) 1316, 1321 (1974). A 25 percent discount was allowed for a minority interest in a corporation that had no history of paying dividends, where the lack of control made it probable that no return on investment could be expected until the liquidation of the corporation. Jack Carr v. Commissioner, 49 T.C.M. (CCH) 507, 514 (1985).

family, as a whole, owned a controlling interest, no discount for minority interest was justified.[67] The Tax Courts[68], the Fifth Circuit[69], the Ninth Circuit,[70] and several district courts[71] did not recognize the family attribution rule and granted minority discounts in family owned companies. The IRS has recently acquiesced to the courts and revoked portions of the family attribution rules.[72]

The general trend appears to show larger discounts being taken. In a 1975 study of sales of minority interests in closely held businesses, the average transaction price was 36 percent below book value. A similar study in 1983 found the average price to be 40 percent below book value.[73]

Albert individually owned a minority interest in the Company. However, as trustee to the Q-Tip trust, his estate owns a majority interest. The estate's position as trustee may provide an opportunity for a small discount. As trustee, it has a fiduciary duty to the beneficiaries of the trust. This limits its ability to withdraw its investment in the corporation.[74] A minority discount of five percent would recognize its limited control.[75]

B. *Discount For Lack of Marketability*

A discount for lack of marketability represents the difficulty a stockholder would have in liquidating his or her ownership interest in the

---

[67] Rev. Rul. 81-253, 1981-1 C.B. 187.

[68] Estate of Woodbury Andrews v. Commissioner, 79 T.C. 485, 494 (1982).

[69] The Estate of Mary Frances Smith Bright v. U.S., 658 F.2d 999, 1005 (5th Cir. 1981).

[70] John Propstra v. U.S., 680 F.2d 1248, 1256 (1982).

[71] Nesta Obermer v. U.S., 238 F. Supp. 29, 35 (1964), Ralph Sundquist v. U.S., 74-2 T.C.M. (CCH) 13035 (1974).

[72] Rev. Rul. 93-12, I.R.C. 1993-8. This ruling has not yet been tested in the courts and the scope of the IRS acquiescence is unclear.

[73] H. Calvin Coolidge, *Survey Shows Trend Toward Larger Minority Discounts*, ESTATE PLANNING, September 1983, p. 282.

[74] In Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990), the tax court recognized that a controlling shareholder, who owed a fiduciary duty to preferred shareholders, had little control over the management of the company's assets and as such was entitled to a minority discount.

[75] Generally, on examination, the IRS is reluctant to favor minority discounts. This position, while aggressive, would provide a point of negotiation on audit. By taking a smaller than normal discount here, the estate can avoid taking the matter to appeal. In this case, because of the size of the interest controlled by Albert's estate, the discount of lack of marketability provides a stronger opportunity for acceptance by the IRS and should be emphasized over the minority discount.

corporation. This discount can be taken in addition to a minority discount as long as the primary basis for taking the discount is not the lack of control.[76]

Quantifying the size of the discount due to the absence of a public market can be the most difficult aspect of valuing an interest in a closely held business.[77] This discount is most accurately determined by comparing the value of restricted stock in a publicly traded company similar to the closely held company being valued. This may be letter stock[78] or stock traded in a private transaction prior to a public offering.[79]

Unfortunately, the lack of publicly traded agricultural corporations make these comparisons virtually impossible when dealing with a farming operation. That leaves very little guidance as to a formulaic measurement of the lack of marketability discount. More than any other aspect of the valuation process, courts have decided issues of this nature on the specific facts and circumstances of each case.[80] A study by Phillip W. Moore found that the decisions of courts vary widely from one decision to the next:

> The discounts vary quite considerably, depending on many factors. However, it is oftentimes not easy to isolate the weight of the so-called "lack-of-marketability factor," and difficult to compare even equal discounts when taken from the varied basis, i.e., net asset value, book value or appraised value.[81]

Moore found a tendency for the discounts to have risen gradually over the years.[82] Although that trend has continued since Moore's study, dis-

---

[76] Melinda Gee Trust v. Commissioner, 761 F.2d 1410 (9th Cir. 1985).

[77] Milton Gelman, *An Economist-Financial Analyst's Approach To Valuing Stock of a Closely Held Company*, JOURNAL OF TAXATION, June, 1972, at 354.

[78] Letter stock is stock in a publicly traded company which is identical in all respects to freely traded shares except that it is restricted from trading on the open market for a period of time. PRATT, *supra* note 59, at 239.

[79] The issuance of letter, or restricted stock, by a publicly traded company is often required to be reported to the Securities Exchange Commission and are therefore a matter of public record. *Id.* at 240.

Information regarding private stock transactions made prior to public offering will most likely be included in the registration statement filed with the Securities and Exchange Commission prior to the public offering. *Id.* at 249.

[80] *Id.* at 262.

[81] *Id.* at 260.

[82] *Id.* at 260, citing Phillip W. Moore, *Valuation Revisited*, TRUSTS & ESTATES, February 1987, pp. 40-52. Moore analyzed fourteen decisions from 1969 through 1982. Grouping them in three time periods he found a gradual increase in the range and average discounts granted:

counts allowed by the courts still fall below those that most studies show as actually taking place in arm's length transactions.[83] It should also be noted that it is not sufficient to base a discount for lack of marketability on the average allowed by the courts. The Internal Revenue Service and the courts will look to what specific evidence the appraiser can supply to substantiate both the need for a discount and the amount.[84]

Because Nelson Farming Company is a family owned business, it has no public market for its shares. Because the Company leases the farmland from members of the family, an outsider would be unwilling to invest in the corporation. A discount for lack of marketability of 25 percent would be appropriate.[85]

These discounts reduce the value of Albert's interest as follows:

Adjusted Value of Corporation	245,500.00
Total Shares Outstanding	÷5,500.00
Subtotal	44.64
Less: Discount For Lack of Marketability (25%)	(11.16)
Subtotal	33.48
Less: Discount For Minority Interest (5%)	(1.67)
Net Value Per Share	31.81

Value of Shares Owned by:	
Estate of Albert	53,430
Q-Tip Trust	58,200
Total	111,630

This creates an estate tax of $362,500. By using the weighted average approach, along with discounts for minority interest and lack of marketability, Albert's estate would owe nearly $100,000 less in taxes at his death. To most farming families, this savings could make the differ-

Years	Number of Cases	Range	Average
1969-1976	4	15 to 25%	18.75
1978-1979	5	10 to 35%	24.00
1980-1982	5	10 to 50%	28.60

[83] *Id.* at 262.

[84] PRATT, *supra* note 59, at 262.

[85] The courts have generally recognized discounts for lack of marketability between 20 and 35 percent. Estate of Gregg Maxcy v. Commissioner, 28 T.C.M. (CCH) 783, 790 (1969), revd. & remd. on another issue 441 F.2d 192 (5th Cir. 1971), Woodrow Colley v. Commissioner, 40 T.C.M. (CCH) 81, 96 (1980). Estate of Albert L. Dougherty v. Commissioner, 59 T.C.M. (CCH) 772, 781 (1990).

ence between passing the farm on to subsequent generations rather than selling it off to pay taxes.

CONCLUSION

There are several reasons, during the normal course of business, why a farming operation would need to determine its value. Nearly every business must have some idea of its worth in order to negotiate financing with a bank. In determining the amount of insurance a company should carry, it must know its value. If the shareholders of a closely held corporation are contemplating selling the business, they need an appraisal of how much the company is worth. If the shareholders desire to retain control of the corporation within a certain group, for instance, a family, through the use of a "buy/sell" agreement, an appraisal would be necessary to set the required redemption or purchase price. Finally, and most importantly for purposes of this comment, in a family-owned corporation, planning to transfer the company from one generation to the next will require determining the value of the corporation for estate and gift tax purposes.

Without taking advantage of the more obscure laws regarding valuing an interest in an agricultural company, heirs would be forced, in many cases, to liquidate farming assets. Using an aggressive position on discounts can further reduce the value to prevent an estate from being unable to pay estate taxes on an interest in the farming operation. Because of the lack of liquidity inherent in family-run farming companies, awareness of these issues is key to being able to transfer the farm from one generation to another.

GARY A. COLBERT, CPA