Taxes, Taxes, Taxes

Valuing Closely Held Stock for Estate & Gift Tax Purposes

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In many cases, the value of an interest in a closely-held business is an individual's primary asset. The value of the closely-held business must be ascertained to adequately perform a thorough and comprehensive estate or financial plan. It may also be necessary to establish the value of an interest in a closely-held business to properly prepare estate or gift tax returns, and to establish the basis of inherited stock in the hands of an heir.

Perhaps the most important elements of a business valuation engagement are in the determination of the purpose and function of the assignment. The standard of value applied by the business appraiser will be determined by the purpose for the engagement. For example, if the business valuation is to be done for a descendant's estate, Internal Revenue Regulation 20.2031-1(b) requires the purpose to be to derive the standard of "fair market value", while the function of the valuation will be to include the standard of "fair market value" on the estate tax return. In a dissenting stockholder action the purpose of the business valuation is to determine "fair value" (defined by individual state statutes and court cases) and the function is to provide the dissenting stockholder fair value in cash.

The standard of "fair market value" is defined, in Revenue Ruling 59-60, as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

There is no single standard or generally accepted formula for establishing the fair market value of a closely-held corporation. Rather, the estimated fair market value must be determined by an objective and thorough analysis of the business. The basic guidelines provided for business appraisers are in Revenue Ruling 59-60, which lists the following eight factors to be considered in the valuation of closely-held businesses:

- The nature of the business and the history of the enterprise from its inception;
- The economic outlook in general and the condition and outlook of the specific industry in particular;
- The book value of the stock and the financial condition of the business;
- The earning capacity of the company;
- The dividend paying capacity;
- The enterprise's goodwill and other intangible values;
- Sales of the stock and the size of the block of stock to be valued;
- The market price of stock of corporations engaged in the same or a similar business and trading stocks in a free and open market either on an exchange or over the counter.

The Ruling further states that, although all relevant factors are to be taken into account, certain factors will carry more weight depending on the nature of a company's business. An experienced appraiser analyzes the business, the industry, and the general economy to arrive at a value for the business as a whole. However, the appraiser should be aware that valuation is both an art and a science and therefore, absolute precision will never be achieved.

In 1987, several professional appraisal organizations formed the Appraisal Foundation, which established the Appraisal Standards Board. The Appraisal Standards Board has developed Uniform Standards of Professional Appraisal Practice (USPAP), of which Standards 9 and 10 relate specifically to performing and reporting on business valuation engagements. In addition to following the guidelines of Revenue Ruling 59-60, it is recommended that business appraisers conform to USPAP. For information regarding a copy of the USPAP rules contact: The Appraisal Foundation, 1029 Vermont Avenue, NW, Suite 900, Washington, DC 20005, (202) 347-7722.

Premiums and Discounts

Once a dollar value for closely-held stock is ascertained, the valuation process is not necessarily complete. Premiums or discounts may need to be applied. Because there is no ready market for such stock, the value for gift or estate tax purposes may need to be adjusted downward. This is referred to as a discount for lack of marketability. The applicability of a discount for lack of marketability may depend on the valuation approach utilized (see Estate of Joseph R. Cloutier V. Commissioner, T.C. Memo 1996-49).

Minority shareholders in a closely-held corporation often are at a distinct disadvantage. Control of the company lies with those holding a majority of the stock. Therefore, minority shareholders do not have the power to determine corporate policies, declare dividends, or to liquidate the business. As such, the value of minority shareholder stock is usually worth less than a pro-rata share of the entire business. This is referred to as a minority interest discount.

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AICPA Issues Exposure Draft Statement of Position for Entities on "Internal Use" Software Accounting

A new Statement of Position (SOP) that would require entities to adopt uniform rules in their financial statements in accounting for the costs of computer software developed or obtained for internal use was issued for public comments by the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA).

The new SOP, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," that was issued as an exposure draft would apply to all non-governmental entities that prepare financial statements in conformity with generally accepted accounting principles (GAAP).

"Currently, there are no authoritative standards on accounting for costs of computer software developed or obtained for internal use. Consequently, a wide range of practice has developed," said Philip D. Ameen, chair of AcSEC's Internal-use Software Costs Task Force. "Some entities now capitalize costs of internal-use computer software, others expense all costs as incurred. Still other entities capitalize costs of purchased internal-use computer software but expense costs of similar software that is developed internally.

"The proposed SOP endorses an approach to software accounting that will cure those inconsistencies without adding significant costs. We trust that the proposal will be reviewed carefully by preparers, users and auditors, and we look forward to their comments on this proposal," he added.

The proposed SOP characterizes internal-use software as software that is acquired, internally developed, or modified solely to meet the entity's internal needs, and that during the software's development or modification, no plan exists to market the software externally.

The proposed SOP does not change any of the provisions relating to computer software that are already covered under existing FASB Statements No. 86 and 2 or FASB Interpretation No. 6.

Specifically, the SOP:

- Provides guidance for determining whether computer software is for internal use;
- Clarifies when internal-use software is and is not in the research and development phase;
- Provides guidance on accounting for the proceeds of computer software developed or obtained for internal use that is subsequently sold;
- Provides guidance on accounting when software consists of more than one component or module.

Written comments on the exposure draft should be sent to Dan Noll, technical manager, Accounting Standards, File 4262, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10035-8775 by April 17, 1997. Comments may also be sent over the Internet to DNoll@aicpa.org.

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Conclusion

Estate and gift tax planning for the owner of a closely-held business requires a comprehensive, supportable business valuation report. The business appraiser should pay careful attention to Revenue Ruling 59-60 guidelines in reaching a valuation conclusion. A minority interest discount and a discount for lack of marketability can significantly reduce the value of stock in a closely-held business and should not be overlooked in the estate and gift tax context.