

## **REVENUE RULING 59-60**

### **A RETURN TO THE BASICS**

In the world of business valuation, IRS Revenue Ruling 59-60 is widely considered one of the founding tenets from which most business valuation emanates, a dicta which lays the foundation upon which business valuation technique proceeds. As such, every once in a while, it is useful to revisit RR 59-60 so as to refresh ourselves with its all important foundational rules.

Clearly, what RR 59-60 tells us is that we need to proceed in a professional, thorough, informed and knowledgeable fashion in order to properly determine the appropriate value (or the appropriate range of value) for a closely-held business.

Section 4.01 of RR 59-60 states "... in the evaluation of the stock of closely-held corporations...all available financial data, as well as all relevant factors affecting their market value, should be considered." In that same section, the Ruling goes on to list eight factors which, while not necessarily all inclusive, are fundamental in business valuation. These factors, and a brief expounding on each, are as follows:

- a) The nature of the business and the history of the enterprise from its inception – certainly, understanding the nature of the business is very important in being able to do an intelligent and reasonably accurate valuation. The more a business is well established, the longer it has been in existence, the relatively less important it is to take into account its history going back to its inception, as contrasted with its more recent history;
- b) The economic outlook in general and the condition and outlook of the specific industry in particular – the relative importance of the general economic outlook as contrasted with the outlook for the specific industry will vary widely depending on the nature of the operation. A business dependent upon the nation's (or even international) financial well-being will usually be viewed differently than one whose fortunes are much more tied to a local economy. In either case, the particular nuances of the specific industry relevant to the valuation process may need to be considered;
- c) The book value of the stock and the financial condition of the business – this provides us with certain basics, including the surface impression of the underlying financial strength of the business. It is one thing to suggest that a business has fantastic prospects for the future – it is another to show that perhaps this business is so fragile in its economic strength that, despite its great prospects, it may not live to realize them;
- d) The earning capacity of the company (income generation) – unless we are looking to the assets of the company as the only source of value (the pieces rather than the ongoing operation), in a sense, income is everything. That is an oversimplification, since developmental stage businesses (as an example) may not have income, but can have substantial value – but nevertheless, in most situations, without income, where is value?;

- e) The dividend paying capacity of the subject business – this is generally not applicable for a closely-held business, especially one where there is no history of dividends. However, we may find this a useful approach where we are dealing with a minority shareholder, and where the business does have a history of paying dividends;
- f) Whether or not the business has goodwill or other intangible value – this of course is one of the most difficult and usually contentious aspects of the valuation process. Does the business have goodwill, and how do we go about supporting our position?
- g) Sales of the stock and size of the block of stock to be valued – for most closely-held business situations, having a sale of stock to use for valuation comparison purposes can be most useful, but at the same time is quite unusual. Even when such a transaction exists, there are typically issues such as whether or not it was at arm's length, the relative size of the block of stock, how stale is the transaction, were there any disguised consulting or other financial arrangements, was it caused by family pressures or age/infirmary, was it estate planning motivated?;
- h) The market price of stocks of corporations engage in the same or a similar line of business having their stocks actively traded in a free or open market, either on an exchange or over the counter – simply put, if there are comparable (that by itself can be a very difficult supposition to support) companies to the subject being valued, where the comparable companies are already public and actively traded on open markets, they may serve as excellent tools for determining the value of the company under consideration. A practical aspect is that this comparability concept can be difficult to apply to a closely-held company, especially to the smaller companies. How truly comparable are these public companies – size comparisons, diversity of product or service, depth of management, capital structure, geographic range, market position or level of influence, etc.;

There is no simple approach, no formula. Keep in mind that Revenue Ruling 59-60 has repeated references to the future – unless one is buying a business to break it up and benefit from its pieces, a business is valued or purchased for what it will yield in the future. Therefore, for whatever faults this brings to the process, the valuation of a closely-held business tends to be a prophecy of the future – as best as can be determined by an expert experienced appraiser.