PART XV: SMALL BUSINESS VALUATION

8873. How is the value of a small business determined? Why is valuing a small business different from valuation in other business contexts?

Small business value, as in other valuation contexts, is usually defined in terms of "market value" or "fair market value," which means the amount a willing buyer would pay a willing seller for property (the individual business interests) or a business enterprise, assuming that each party to the transaction has reasonable knowledge of all material facts and that neither is under a compulsion to buy or sell. In the small business context, valuation is often problematic because, typically, there is no established secondary market in which the business interests are bought and sold, whereas a larger entity may be traded on an established market so that its fair market value is easily established by current trading prices.

Further, the business owners are typically very involved in the day-to-day operations and management of a small business—meaning that the current owners' exit from the business can dramatically impact the business' future operations and, thus, its current value.

Often, valuation issues in the small business context become important when the owner-managers seek to transfer their interests in the business to related parties—typically children or grandchildren. Even if these business succession plans are structured as bona fide sales, rather than outright gifts, the IRS is more likely to closely scrutinize the transaction in order to ensure that the interests were valued based on their market value, however limited, to avoid transitioning the business using artificially low values in order to disguise a gift transaction.

Similarly, estate tax valuation is often important in the small business context because of the lack of an established market to provide an objective valuation benchmark for determining the value that must be included in a deceased owner's taxable estate.

Because of these factors, the IRS has recognized that there is no one exact formula that can be used in valuing a small business, and that the valuation process, by its nature, requires a fact intensive inquiry over which even independent expert appraisers might disagree.[1] Despite this, a series of general principles governing valuation of small business interests has emerged to provide guidance to the small business owner. At a high level, three methods of business valuation exist: asset valuation, income valuation and market valuation. The asset valuation approach (an asset sale) is often the default if no action is taken by the business owner and/or if the business owner dies while in business. Although the details can get complicated as it applies to specific fact situations, this method simply involves taking the sum of the assets and subtracting the liabilities to find the value of the business. This method is not appropriate for certain types of businesses. In the case of professional service organizations comprised of professionals such as attorneys, doctors, accountants and financial planners, the business' tangible assets can be of negligible value, which could cause a vast undervaluation of the business.

Income valuation and market valuation are discussed at Q 8877 and Q 8878.

1. Rev. Rul. 59-60, 1959-1 CB 237.

General valuation principles are discussed in Q 8874, while Q 8875 outlines the potential impact of a buy-sell agreement upon valuation. Q 8876 addresses some of the more specific issues that arise when the business interests are composed of corporate stock.

Special estate tax valuation rules are discussed in Q 8884. See Q 8852 to Q 8872 for a discussion of business succession planning in general.

8874. What general principles govern small business valuation for estate and gift tax purposes?

The fair market value of any interest in an "unmarketable business," whether it is structured as a partnership, corporation, limited liability company, or a proprietorship, is the amount that a willing buyer, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. The net value is determined on the basis of all relevant factors, including the following:

(1) The value of all the assets of the business, tangible and intangible, including goodwill (see Q 8879 and Q 8880);

(2) The demonstrated earning capacity of the business; and

(3) The other factors set forth in the regulations[1] relating to valuation of corporate stock, to the extent applicable.

Adequately determining the value of a small business' "goodwill" requires special attention, as it is an especially fact intensive determination. Complete financial and other data upon which the valuation is based should be submitted with the relevant tax return, including copies of reports of examinations of the business made by accountants, engineers, or any technical experts as close to the applicable valuation date as possible.[2]

Professional appraisers, courts and the IRS generally follow the principles laid out in Revenue Ruling 59-60 when valuing the stock of a closely-held corporation or the stock of corporations where market quotations are not readily available. The factors outlined in Revenue Ruling 59-60 also apply in valuing interests of other business entities, such as closely-held partnerships or LLCs, for gift tax or estate tax purposes.

Typically, in a valuation challenge today, the courts will adopt a "winner take all" approach, rather than seeking a compromise position between the two parties' competing valuation proposals. This is because the Tax Court has found that the "compromise the difference" approach that was historically used by the courts merely encouraged the parties to assert extreme values, forcing the courts to determine a reasonable middle ground between those two extreme positions.

1. See Treas. Regs. §§20.2031-2(f), 20.2031-2(h), 25.2512-2(f).
2. Treas. Regs. §§20.2031-3, 25.2512-3.

The Tax Court adopted its "winner take all" approach in a 1980 valuation decision, *Buffalo Tool & Die Manufacturing Company, Inc. v. Commissioner*,[1] finding that the parties were fully capable of reaching an agreement themselves in order to avoid the judicial process (and the related expenses) altogether. Therefore, the court reasoned that the threat that the other party's valuation approach would be adopted in its entirety would motivate more careful analysis by the parties before resulting to judicial intervention. This is the approach that the majority of courts now take with respect to valuation decisions.[2]

8875. How does the existence of a buy-sell agreement impact small business valuation?

As discussed in Q 8852 to Q 8865, a buy-sell agreement can function as an important business succession planning tool, as it allows the business owners to plan for the orderly withdrawal of one or more business owners and will specify a predetermined method for determining the price of the business interests. Despite this, IRC Section 2703 provides that the value of any interest must be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to the option, agreement, or other restrictions) or any restriction on the right to sell or use the property (i.e., buy-sell agreement), unless the agreement meets the following requirements:

(1) It is a bona fide business arrangement;

(2) It is not a device to transfer the property to members of the decedent's family for less than full or adequate consideration; and

(3) It has terms comparable to those entered into by persons in an arm's length transaction.[3]

Assuming these requirements are met, it is possible that the *estate tax* value of a business interest (including closely-held stock) may be controlled by the price or formula contained in a buy-sell agreement.

Though the facts of each case must be examined to determine whether the agreement price will be accepted for estate tax purposes,[4] case law has established that if the following conditions are met, the agreement price will hold, even though the fair market value of the business interest may be substantially more at the valuation date than the agreement price:

(1) The estate must be obligated to sell at death (under either a mandatory purchase agreement or an option held by the designated purchaser, see Q 8856);

1. 74 TC 441.
2. *Est. of McGill v. Comm.*, TC Memo 1984-292 (voting trust certificates); *Est. of Gallo v. Comm.*, TC Memo 1985-363 (closely held stock); *Est. of Gillet v. Comm.*, TC Memo 1985-394 (closely held stock); *Est. of Rubish v. Comm.*, TC memo 1985-406 (ranch); *Est. of Watts v. Comm.*, TC Memo 1985-595 (partnership interest).
3. IRC Sec. 2703.
4. Treas. Regs. §§20.2031-2(h), 20.2031-3; Rev. Rul. 59-60, 1959-1 CB 237.

(2) The agreement must prohibit the owner from disposing of his interest during his lifetime at a price higher than the contract or option price;

(3) The price must be fixed by the terms of the agreement or the agreement must contain a formula or method for determining the price; and

(4) The agreement must be an arm's length business transaction and not a gift. Thus, the purchase price must be fair and adequate at the time the agreement is made, particularly if the parties are closely related.[1]

Therefore, the price set in a buy-sell agreement was found to control valuation issues in a number of cases involving estate tax valuation where these requirements were satisfied.[2] For gift tax purposes, however, an agreement restricting lifetime sale will be considered with all other pertinent factors, and may tend to lower the value of the business interest.[3]

If a business purchase agreement calls for shares to be purchased from an estate with installment purchase notes bearing a rate of interest lower than the market rate at the date of death, an executor may be allowed to discount the value of the shares by the difference between the interest rate called for in the buy-sell agreement and the prevailing rate at the date of death.[4]

A first-offer agreement, under which survivors have no enforceable right to purchase the business interest and can purchase the interest only if the executor wishes to sell, does not fix the value of the interest for estate tax purposes.[5]

If an agreement is between closely related persons and is found to be merely a scheme for avoiding estate taxes, the price set in the agreement will not control.[6] A buy-sell agreement is not binding unless it represents a bona fide business agreement and is not testamentary in nature.[7] An agreement may be found to be a scheme for avoiding estate taxes, however, even if it also serves a bona-fide business purpose.[8]

No effect will be given to an option or contract under which a decedent is free to dispose of the interest or shares at any price he or she chooses during life.[9]

1. *Slocum v. U.S.*, 256 F. Supp. 753 (S.D.N.Y. 1966).
2. *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955); *May v. McGowan*, 194 F.2d 396 (2nd Cir. 1952); *Comm. v. Child's Estate*, 147 F.2d 368 (2nd Cir. 1952); *Comm. v. Bensel*, 100 F.2d 639 (3rd Cir. 1939); *Lomb v. Sugden*, 82 F.2d 166 (2nd Cir. 1936); *Wilson v. Bowers*, 57 F.2d 682 (2nd Cir. 1932); *Mandel v. Sturr*, 266 F.2d 321 (2nd Cir. 1959); *Fiorito v. Comm.*, 33 TC 440, acq. 1960-1 CB 4; *Est. of Littick*, 31 TC 181, acq. in result, 1984-2 CB 1; *Est. of Weil*, 22 TC 1267, acq. 1955-2 CB 10; *Est. of Salt*, 17 TC 92, acq. 1952-1 CB 4; *Est. of Maddock*, 16 TC 324, acq. 1951-2 CB 3. See also Treas. Regs. §§20.2031-2(h), 20.2031-3.
3. *Est. of James v. Comm.*, 148 F.2d 236 (2nd Cir. 1945); *Kline v. Comm.*, 130 F.2d 742 (3rd Cir. 1942); *Krauss v. U.S.*, 140 F.2d 510 (5th Cir. 1944); *Comm. v. McCann*, 146 F.2d 385 (2nd Cir. 1944); *Spitzer v. Comm.*, 153 F.2d 967 (8th Cir. 1946); Rev. Rul. 189, 1953-2 CB 294.
4. Let. Rul. 8245007.
5. *Worcester County Trust Co. v. Comm.*, 134 F.2d 578 (1st Cir. 1943); *City Bank Farmers Trust Co. v. Comm.*, 23 BTA 663 (1931), acq. 1932-1 CB 2; *Michigan Trust Co. v. Comm.*, 27 BTA 556 (1933).
6. *Slocum v. U.S.*, 256 F. Supp. 753 (S.D.N.Y. 1966).
7. *Est. of True v. Comm.*, 2004-2 USTC ¶60,495 (10th Cir. 2004).
8. *St. Louis County Bank v. U.S.*, 49 AFTR 2d ¶1509 (8th Cir. 1982).
9. *Est. of Caplan v. Comm.*, TC Memo 1974-39; *Est. of Gannon v. Comm.*, 21 TC 1073 (1954); *Est. of Trammell v. Comm.*, 18 TC 662 (1952), acq. 1953-1 CB 6; *Est. of Mathews v. Comm.*, 3 TC 525 (1944); *Hoffman v. Comm.*, 2 TC 1160 (1943); *Est. of Tompkins v. Comm.*, 13 TC 1054 (1949); Rev. Rul. 59-60, 1959-1 CB 237.

On the other hand, an agreement that restricts sale during life, but not at death, also will fail to fix the estate tax value.[1]

8876. How are shares of stock valued in a closely-held corporation ?

IRC Section 2031(b) governs valuation, for estate tax purposes, of unlisted stocks and securities. Essentially, this provision provides that the value of securities of corporations involved in the same or similar business may be considered in cases where the small business at issue has no readily available market price because its interests are neither listed on a public exchange nor frequently traded.

Revenue Ruling 59-60 contains a broad discussion of factors that the IRS believes should be considered in valuing shares of stock in closely-held corporations or in corporations where market quotations are either lacking or too scarce to be recognized.[2] The IRS has found that in these cases, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following nonexhaustive list of factors are important in this analysis:

(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 (see Q 8881);

(3) The book value of the stock and the financial condition of the business;

(4) The business' earning capacity;

(5) The business' dividend-paying capacity;

(6) Any goodwill or other intangible value that can be attributed to the business (see Q 8879 and Q 8880);

(7) Sales of the stock and the size of the block of stock to be valued (see Q 8883); and

(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 (see Q 8877).[3]

In general, when valuing an operating company that sells goods and services, primary consideration is given to earnings, and when valuing a company that merely holds investments, primary consideration is given to asset values. However, if a company is not easily characterized as one or the other, both earnings and assets must be considered.[4] For a discussion of the impact of a buy-sell agreement on valuation, see Q 8545.

1. *Land v. U.S.*, 303 F.2d 170 (5th Cir. 1962).
2. 1959-1 CB 237.
3. Rev. Rul. 59-60, Sec. 4.01.
4. *Martin v. Comm.*, TC Memo 1985-424.

8877. What is the market valuation approach used in valuing closely-held business interests?

The market valuation approach to valuing closely-held business interests attempts to determine the value of stock in a closely-held corporation by comparing it to the price of publicly traded shares in a comparable business. Revenue Ruling 59-60 guidelines (discussed in Q 8876) suggest that comparable business entities in the same or similar line of business must be identified as a starting point in this analysis. Once one or more comparable entities are located, their price/earnings (P/E) ratio must be determined. The P/E ratio is the price per share divided by the earnings of the applicable stock over the most recent 12 month period. This ratio illustrates the investor interest in the stock based on its current selling price on a recognized exchange or on the over-the-counter market.

When evaluating stock of a comparable publicly traded company, it should be remembered that only a small portion of the capital stock issued and outstanding is traded daily. As a result, such trades represent only minority-interest trading. Nevertheless, the P/E ratio of stock in a comparable publicly traded company is relevant because unlike closely-held shares, publicly traded stocks have daily marketability through their respective exchanges, so price is always a known factor.

P/E ratios may fluctuate due to special situations—extraordinary losses or gains may occur in one year or the sale of a subsidiary may cause fluctuations. Moderate P/E fluctuations should be disregarded. However, if a company exhibits wide variations due to extraordinary losses or gains, it may be too volatile to be used as a meaningful basis for comparison.

Marketability Discount

The discussion concerning market valuation assumes that what is being sold or purchased is some type of minority share value with daily marketability. However, there is rarely a ready market for shares in a closely-held company. In addition, most closely-held companies do not provide financial data to the public and may not even provide it to minority shareholders. Finally, closely-held companies frequently place restrictions on stock.

All these “unknowns” work to limit the marketability of closely-held stock and introduce a marketability discount. Such discounts may range anywhere from 10 percent to 50 percent or more. (The larger discounts usually apply to minority blocks as opposed to controlling interests.) Marketability discounts must be determined on a case by case basis. Ultimately, the exact amount of the discount may not be known until the seller and buyer agree on a price per share. Nonetheless, it should be remembered that closely-held stock will almost always be valued at a lower rate than comparable publicly traded stock because of the marketability discount associated with closely-held companies (see Q 8873). See Q 8883 for a detailed discussion of the application of control premiums and minority discounts in small business valuation.

8878. What is the income valuation approach that is used in valuing closely-held business interests?

The income approach to valuing closely-held business interests is primarily based on an estimation of future earnings capacity. The first step in the process of calculating future earnings is to obtain any financial plans prepared by the company. The next step is to project the company's cash flow for a minimum of five years. These projections should be based on information about the recent past, including the company's profit-and-loss statements. Company sales and income are also frequently used to predict future cash flow.

In cases where the company has an erratic history of sales and earnings, the process may become more complex. In these situations, the reason behind the irregular financial past must be determined. An important element in this analysis involves determining whether the company is operating in a cyclical industry prone to yearly swings in sales and income. If so, other industry firms can be expected to show similar cyclical behavior. Recognizing an industry cycle should provide clues to future financial performance.

If the industry is non-cyclical, firm records must be reviewed to determine the specific reasons or events that caused the erratic history. Questions to ask include:

(1) Does the company face heavy debt?

(2) Is management lacking in experience or depth?

(3) Have products not been brought to market in a timely manner?

(4) Has growth been too rapid?

(5) Was expansion poorly planned?

A problem in any of these areas may signal problems in the future as well.

When predicting cash flow, the standard practice is to forecast five years into the future and discount each year's cash flow back to present value, by using a market-indicated rate of return. Risks faced generally by the industry in which the company operates should also be factored into this equation. The fifth year value of the company must be estimated by capitalizing the fifth-year cash flow, using an appropriate rate of return that considers both company and industry risk. The fifth year value is translated into present value by using a discount rate derived from the market rate.

The sum of the discounted cash flows for five years and the present value of the capitalized fifth year results in the fair market value of the company under this valuation approach.

8879. How is "goodwill" important in valuing small business interests?

Goodwill is an intangible business asset that includes attributes such as the business' reputation, client and supplier relationships and potential for repeat business. In the closely-held business context, IRS Revenue Ruling 59-60 specifically identifies goodwill as a factor that must be valued in order to determine the company's overall fair market value.

An important consideration in determining the presence of goodwill, and whether this goodwill is transferable, involves whether the general performance of the business depends upon a certain individual or a group of individuals. If this is the case, this goodwill may be lost if the business is sold without the continued participation of these individuals.[1]

1. See *Zorniger v. Comm.*, 62 TC 435 (1974), *Akers v. Comm.*, 6 TC 693 (1946), *Norwalk v. Comm.*, T.C. Memo 1998-279.

Though the IRS has recognized that the personal skill of one owner or a group of owners often cannot (or will not) be sold along with the business,[1] it has recognized that such skill can add substantially to the value of the business by enhancing the reputation of that business.[2] However, in order for the value of the business to be increased by the goodwill established by departing business owners, the IRS requires that those departing owners relinquish all rights to that goodwill. Therefore, for example, if a business owner or group of owners sell their business without allowing the purchasers to use their existing business name, no goodwill has been transferred that would increase the value of the business.[3]

8880. What factors are used in determining the intangible value of a small business?

As is typical in small business valuation, the IRS has indicated that the extent to which a business' value is attributable to intangible value in the form of goodwill must be determined on a case by case basis.[4] At its most basic level, the value that exceeds the value of the business' tangible assets is attributed to its goodwill. Goodwill is determined by deciding how much a purchaser would pay for this excess value, which is the product of intangibles such as reputation and market position (see Q 8879).

Because of the fact-intensive nature of the inquiry, there are no specific factors that must be considered in determining the goodwill of a small business. Often, the value of goodwill will depend upon the business' earning capacity and projected future earning capacity, but it can also include value attributable to the business' prestige, whether it owns a trademark or brand name and its record of successful operation over a prolonged period of time.[5]

A business that derives much of its success from the services provided by its owners, such as a group of doctors or accountants, will often assign significant value to the goodwill generated by the reputations of these professionals. Conversely, if the business is primarily asset-driven, where the physical equipment or structures producing a product may be more important than the personal services of a business owner, goodwill may be assigned a lesser value. However, even in a product-driven business, if the reputation of concrete products produced by the business provides motivation for repeat business, the business' goodwill should be assigned a higher value.

The courts have held that the value of personal relationships established by a shareholder-employee or other business owner are generally not corporate assets, and therefore may not be considered in determining the value of goodwill, unless the individual has committed to continuing services to the business, whether contractually or otherwise. In this context, non-compete agreements and traditional employment agreements may be useful in establishing such a commitment.[6]

1. See *Providence Mill Supply Co. v. Comm.*, 2 BTA 791 (1925).
2. Rev. Rul. 64-235, above.
3. Rev. Rul. 57-480, 1957-2 CB 47.
4. Rev. Rul. 64-235, above.
5. Rev. Rul. 59-60, 1959-1 CB 237.
6. *Martin Ice Cream Co. v. Comm.*, 110 TC 189 (1998).

Because the standards for valuing goodwill are so amorphous, the IRS has proposed a formula that may be used to value goodwill in the event that the parties are unable to assign value based upon past earnings performance and perceived reputational value. Under this formulaic approach, the owners must first determine the return on the average annual value of the business' tangible assets over a period of time (the IRS recommends five years). The percentage of returns that are based on tangible assets is subtracted from the total average earnings of the business over the same period of time. The remaining value is considered to represent earnings from the business' intangible assets, including goodwill. This value is then capitalized (at a suggested rate of 15 to 20 percent, depending upon the individual level of business risk) to allocate a value to those intangible assets.[1]

Any abnormal years should be excluded from the period used for averaging under this formula. In determining the rate of capitalization that is most appropriate, the IRS has indicated that the owners must consider factors such as (1) the nature of the business, (2) the risks involved in the business and (3) the stability or irregularity of earnings.

It is important to note that the IRS only recommends use of this formula if the parties are unable to otherwise realistically assign value to a business' goodwill through another reasonable approach that is based on factors more specific to the particular business.

8881. What types of external risks are important in determining the value of a small business?

As in any other business context, the value of a small business may be substantially impacted by external pressures and risk factors. As such, the IRS recognizes that the general economic outlook and industry-specific risk factors must be considered in determining the overall value of the business.[2]

In this analysis, it is important to identify industry trends that have emerged, and whether the business' management is aware of these trends and planning to take advantage of them in their future business plans. While general economic outlook is an important consideration in assigning value to a business, the parties must also consider whether the small business in question tends to prosper in proportion to general economic conditions, or whether its performance is counter-cyclical. If the business' performance is counter-cyclical, valuation must account for the fact that a general market downturn could represent a period of growth within the industry that the business operates.

Investor perceptions toward the industry in which the business operates can also serve as a predictor of current and future business value. To this end, examination of comparable businesses that are traded more regularly can aid in determining the potential for increased value in the small business based on industry performance. The IRS, therefore, recognizes that the market prices of stocks of corporations engaged in the same or similar lines of business with actively

1. Rev. Rul. 68-609, 1968-2 CB 327.
2. Rev. Rul. 59-60.

traded stock, either on an exchange or over-the-counter, can be important in determining investor perceptions that can influence future value.[1]

Further, it is important to identify the business' position in the industry with respect to its competitors. In this analysis, whether the individual business is more or less successful than competitors is important, but it is also important to determine whether the industry in which that business operates is competitive with respect to other industries. It must also be determined whether a company that is more successful than its competitors is poised to continue this success. For example, if a company's success is based largely upon the fact that it has developed a product that is new to the market, whether it can maintain this advantage is critical to anticipating future success.[2]

The courts have also made clear that, in any analysis that determines value partially based upon other business' performance, the comparable businesses that are selected must be appropriately comparable to the small business valuation at issue. For example, the performance of the securities of a holding company, where the primary issue is asset performance, are not appropriately comparable to the potential performance of an operating company, where the primary concern is earnings capacity, and thus should not be used to determine value.[3]

While there is no formula for determining the impact of various external factors upon the value of a particular small business, the fact-intensive inquiry generally includes an evaluation of the following nonexhaustive list of issues:

(1) Status of the local labor market;

(2) The company's reliance on other entities for goods or services;

(3) The risk or anticipation of merger or acquisition;

(4) The existence of pending or potential litigation,

(5) The local, regional and national economies and forecasts; and

(6) The nature and extent of competition within the company's field.[4]

Both the relevance and the weight accorded to any one of these factors will depend upon the nature of the business and the industry and geographic location in which it operates.

8882. How does the current management structure of a small business impact valuation?

Generally, a small business whose future prospects are completely dependent on the current management team is at a much greater risk and, as a result, less valuable than a company

1. See also the IRS' Business Valuation Guidelines IRM 4.48.4.2.3 (July 1, 2006).
2. Rev. Rul. 59-60.
3. *Estate of Ford v. Comm.*, TC Memo 1993-580.
4. Klaris, *"Valuing the Family Business,"* 129 Tr. & Est. 18 (Feb. 1990).

with good management backup and a well organized system of delegation. The organizational structure of the small business and the degree of control that the business owners exercise over the actual operations are important in determining the impact that the current management structure will have on the value of the business.

As discussed in Q 8879 and Q 8880, in a business where emphasis is placed on the performance of services by specified individuals, rather than the supply of goods through use of tangible assets owned by the business, the presence or absence of these individuals has a much more substantial impact on the business' value.[1] Similarly, where, as many small businesses, operations are directed entirely by a small group, retention of these individuals can be key to maintaining the value of the business. The loss of individuals who have been key to a business' success can reduce the value that should be assigned to that business, especially if there is no succession plan in place.[2]

The IRS has recognized, however, that such losses can be offset, such as through the use of insurance funding, as in a buy-sell agreement where the company has purchased insurance to help sustain operations if a key owner dies or otherwise withdraws from the business (see Q 8855).[3] Such an offset must, therefore, be taken into account when assigning weight to the valuation impact of the current management structure, whether through the retention or loss of certain individuals' services.

8883. How can a majority or minority interest impact the value of a small business interest?

If a block of stock represents a controlling interest in a corporation, a "control premium" may add to the value of the stock. If, however, the shares constitute a minority ownership interest, a "minority discount" is often applied to the value. For example, in *Martin v. Commissioner*,[4] discounts were applied to shares of stock representing a minority interest in a holding company that, in turn, held minority interests in seven operating companies. In this case, lack of control over both the holding and operating companies, combined with a lack of marketability (see Q 8877), led the court to allow a combined 70 percent discount in valuing the interests.

A premium may also attach for swing vote attributes where one block of stock may exercise control by joining with another block of stock.[5] The IRS has valued stock included in the gross estate at a premium as a controlling interest, while applying a minority discount to the marital deduction portion which passed to the surviving spouse.[6]

However, the fact that an interest being valued is a minority interest does not always mean that a minority discount is available. Courts have held that, even though the interests at issue are minority interests, a minority discount is not appropriate if there is nothing lost through the minority ownership position. For example, in a case where the decedent owned minority

1. See *Providence Mill Supply Co. v. Comm.*, 2 BTA 791 (1925), Rev. Rul. 64-235, above.
2. Rev. Rul. 59-60.
3. Rev. Rul. 59-60, above.
4. TC Memo 1985-424.
5. TAM 9436005.
6. TAM 9403005.

interests in five partnerships, no discount was available because the partnership agreement required the partnerships to distribute cash flow annually based on a predetermined formula. Therefore, the majority partners would not be able to prevent or alter the partnership distributions and there was no risk that the minority owner would not receive an annual payout.[1]

If a donor transfers shares in a corporation to each of the donor's children, the IRS will no longer consider family control when valuing the gift under IRC Section 2512. Thus, a minority discount will not be disallowed solely because a transferred interest would be part of a controlling interest if such interest were aggregated with interests held by family members.[2] Accordingly, a minority discount has been allowed even when the person to whom the interest was transferred was already a controlling shareholder.[3]

The Tax Court has determined that an estate would not be allowed a minority discount where the decedent transferred a small amount of stock immediately prior to death for the sole purpose of reducing her interest from a controlling interest to a minority interest for valuation purposes.[4] Also, a partnership or LLC may be included in the gross estate under IRC Section 2036 without the benefit of discounts if a decedent transfers all of his or her assets to the partnership or LLC and retains complete control over the income of the partnership or LLC.[5]

8884. What special estate tax valuation issues must be considered in the small business context?

In recognition of the limited marketability of closely-held family businesses, and in an effort to encourage the continued operation of these businesses after the death of the business owner, Congress enacted IRC Section 2032A to potentially ease the estate tax liability of successors to family businesses. If the family business includes ownership of real estate used in the business, the estate may be able to take advantage of this special use valuation provision in valuing the real property for inclusion in the gross estate.

Generally, real property is valued on the basis of its "highest and best use," which typically leads to a valuation that reflects the upper limit of the property's potential value. However, a "current use" approach is available for qualified real property used for farming purposes or in certain trades or businesses. "Qualified real property" used in a closely-held business may also qualify for special use valuation.[6] An estate's executor can elect to value qualified real property used in a closely-held business on the basis of its *actual* use in the business, rather than its highest and best use, if the requirements of IRC Section 2032A, discussed below, are satisfied.

Planning Point: As it applies to real property, farmers and ranchers often feel asset rich and cash poor. The estate tax issues they face are significant and not easily solved. One option to consider are "land grant" non-profit organizations that preserve the ranching/farming heritage and avoid liquidation due to taxes.

1. *Godley v. Comm.*, 2002-1 USTC ¶60,436 (2002) (partnerships held housing projects subject to long-term government contracts).
2. Rev. Rul. 93-12, 1993-1 CB 202, revoking Rev. Rul. 81-253, 1981-2 CB 187.
3. TAM 9432001.
4. *Est. of Murphy v. Comm.*, TC Memo 1990-472.
5. *Est. of Strangi v. Comm.*, TC Memo 2003-145; *Kimbell v. U.S.*, 2003-1 USTC ¶60,455 (2003).
6. IRC Sec. 2032A(a)(1).

The aggregate decrease in the business value permitted through special use valuation under Section 2032A is $1,090,000 for decedents dying in 2014, as indexed annually for inflation.[1]

Section 2032A valuation may be elected if: (1) the qualified property is owned by a U.S. citizen or resident and (2) the executor makes the election under Section 2032A(d)(2).[2] Qualified real property is real property located in the United States where the following additional conditions are satisfied:

(1) *Substantial and historical usage*. The IRC Section 2032A election is only available to estates in which a farming or other closely held business comprises a substantial part of the estate. The following requirements apply:

(a) (i) 25 percent or more of the adjusted value of the decedent's gross estate must consist of the adjusted value of real property used in the business, and (ii) 50 percent or more of the adjusted value of the gross estate must consist of the adjusted value of real or personal property used in the business;[3] and

(b) During the eight years immediately preceding the decedent's death, the decedent, or a member of his family, must have (i) owned and used the property[4] and (ii) materially participated in the business.[5]

(2) *Future usage to prevent recapture*. Because IRC Section 2032A is intended to encourage continued future use of the property, each person with an interest in the property must sign a written consent to a special recapture tax set forth in 2032A(c).[6] This requirement is imposed in furtherance of the goal of encouraging the decedent's heirs to continue the business rather than being forced to sell in order to meet tax liabilities.[7]

The recapture tax is imposed if the heir (1) disposes of any interest in the qualified small business property to a non-family member or (2) ceases to use the property for a qualified use (meaning use within the closely-held business) within 10 years of the death of the decedent and before the death of the qualified heir.[8] Essentially, a "qualified heir" is an heir who is either (1) a surviving spouse; (2) an heir who has not yet reached the age of 21; (3) a disabled individual; or (4) a student.[9]

The numerous requirements imposed under IRC Section 2032A, along with its limited applicability in the estate tax context, naturally mean that the valuation approach will only be useful in limited circumstances.

1. See Rev. Proc. 2013-35, 2013-47 IRB 537.
2. IRC Sec. 2032A(b).
3. IRC Sec. 2032A(b)(1)(A) and (B).
4. IRC Sec. 2032A(b)(1)(C) and (A)(i); Treas. Reg. §20.2032A-3(c)(1) and (d).
5. IRC Sec. 2032A(e)(6) provides that material participation will be determined as under IRC Sec. 1402(a)(1).
6. IRC Sec. 2032A(d)(2).
7. See *Stovall v. Commissioner*, 101 TC 140 (1993).
8. IRC Sec. 2032A(c).
9. IRC Sec. 2032A(c)(7)(C).