Business Valuation

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* The authors would like to thank Cathy Durham for her assistance in the
  preparation of this chapter.
I. [§ 9.3.1] Scope of Chapter

This chapter gives a brief overview of the methods by which the value of a business may be estimated for purposes of a sale or assumed sale. The chapter will first discuss why there are different values for a business; that is, how the motivations, investment objectives, and negotiating positions of the buyer and seller affect the value of the business. See infra § 9.3.2. The chapter will then discuss the initial valuation considerations, focusing on the subject of the valuation. See infra §§ 9.3.3–.5. Then the chapter will explore various definitions of value, see infra §§ 9.3.6–.9, and delve into the valuation process itself, see infra §§ 9.3.10–.19. Finally, the chapter discusses four specific topics in valuation: allocating business enterprise value to specific ownership interests, see infra § 9.3.20; discounts and premiums, see infra § 9.3.21; consideration of subsequent events, see infra § 9.3.22; and reconciliation of value conclusions, see infra § 9.3.23.

II. [§ 9.3.2] In General

There is no one value for a business enterprise or an ownership interest in that business. Different buyers and sellers will determine different values for the same business interest, and their opinions of value will change over time.

The price paid for a business interest in an actual sale reflects the motivations, investment objectives, and negotiating positions of a specific buyer and seller.
The following chart illustrates why different buyers would be willing to pay different prices for the same business enterprise.

<table>
<thead>
<tr>
<th>Prospect Ranking Chart</th>
<th>Buyers of a Business Enterprise</th>
<th>(A Generalization About Relative Value)</th>
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<tbody>
<tr>
<td><strong>Highest Enterprise Value</strong></td>
<td></td>
<td></td>
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<tr>
<td>9</td>
<td>Strategically Positioned Businesses in the same industry or market that would employ their own business plan to (1) realize the added economic benefits of vertical or horizontal integration (synergy) or (2) realize the economic benefit of eliminating competition.</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Diversifying Businesses that have their own business plan to aggressively enter competition in the seller’s industry and that desire the seller’s business and management as the nucleus of this planned growth.</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Competing Businesses within the same industry, concerned that sale of the business to a more aggressive competitor would adversely affect their own market position and business plan.</td>
<td></td>
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<tr>
<td>6</td>
<td>ESOPs that will be organized to use the income tax and borrowing benefits of an Employee Stock Ownership Plan to enhance their proposed purchase offer.</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Outside Investors/Managers who will be owners/managers and who possess deep management skill, knowledge, and experience within the seller’s industry and markets.</td>
<td></td>
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<tr>
<td>4</td>
<td>Insider Management Group that has intimate knowledge of the seller’s business, which greatly reduces the investment risk but also may give the group potentially intimidating leverage if the seller lacks management.</td>
<td></td>
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<tr>
<td>3</td>
<td>Diversified Financial Investors who have no interest in a job, who will take on the seller’s management team and business plan and who have a diversified investment portfolio.</td>
<td></td>
</tr>
</tbody>
</table>
2 Investor/Job Seeker who desires both the investment opportunity and an executive position within the seller’s business.

1 Undiversified Financial Investors who have no interest in a job, who lack a diversified investment portfolio, and who will take on the seller’s management team and business plan.

Lowest Enterprise Value

Valuations done in actual sales are usually done to support the reasonableness of the price reached by the buyer and seller or determine whether the price to be paid is “fair.” Actual or market transactions might include a valuation to be used for buying or selling all or a partial interest in a business, for a merger, or for an initial public offering or business dissolution.

The value of a business interest may be determined when no actual sales negotiations are contemplated. The value determined for a business interest in a hypothetical sale reflects the assumed negotiating positions of general, but not specifically identified, buyers and sellers.

In a hypothetical sale, a specific buyer and seller may be known, but there are no arm’s-length negotiations between the parties to determine a price for the business interest transferred. Instead, specific valuation standards and methods are applied to determine a value for the transferred interest.

An assumed sale transaction is required for gift and estate, divorce, and ownership succession planning valuations. In these instances, “value” is transferred, but there may not always be a cash payment equal to the business interest’s value.
III. [§ 9.3.3] Initial Valuation Considerations

A. [§ 9.3.4] Key Determinants in All Business Interest Valuations

The key to all business interest valuations is determining the following:

1. Subject of the valuation;
2. Purpose of the valuation;
3. Standard or definition of value;
4. Premise of value; and
5. Date of valuation.

B. [§ 9.3.5] Subject of the Valuation

The subject of the valuation may be the entire business or a specific ownership interest in the business enterprise.

A business enterprise is a commercial, industrial, service, or investment entity pursuing an economic activity.¹ An ownership interest in the business enterprise is typically some portion of the equity interest in the business enterprise. The legal organization of the business enterprise—sole proprietorship, general or limited partnership, corporation, or limited liability partnership or corporation—often dictates the form of ownership interest.

The purpose of the valuation often dictates the applicable definition and approaches to value. For example, a valuation for federal gift tax purposes determines the fair market value² of the gift, whereas a valuation for a dissenting stockholder action determines the fair value³ of a stock interest.

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² See infra § 9.3.7.
³ See infra § 9.3.8.
The various types of values that can be determined for a business enterprise or an ownership interest in that business include

1. Fair market value;
2. Fair value;
3. Investment value;
4. Intrinsic value;
5. Liquidation value; and

These different values are discussed below.

The premise of value is the set of circumstances or the perspective for the valuation. In most situations, the business is valued as a going-concern, although in some instances liquidation of the business may be appropriate. The valuation of a minority ownership interest typically assumes continuation of the current management and business plan because a minority owner lacks the voting power to change the direction of the business. The valuation of a controlling interest, however, may consider alternative business plans and their effect on value.

The date of valuation is a specific past, current, or future date. This date is important because it determines the information that can be considered in assessing value. Estimating historic value requires the business appraiser to consider only information that was available or reasonably foreseeable as of the date of the valuation, and to ignore what actually happened. On the other hand, an estimate of value as of a future date requires the business appraiser to make reasonable projections of future performance for the business being valued as well as of industry and economic conditions affecting the business.
IV. [§ 9.3.6] Definitions of “Value”

A. [§ 9.3.7] Fair Market Value

Fair market value is typically defined as “the price 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 relevant facts.”⁴ This definition of fair market value is applicable to valuations involving federal estate, gift, and income taxes. A similar definition of fair market value is used for divorce in Wisconsin, although the interpretative case law differs from the tax case law and regulations.

For federal tax valuations, it is assumed that the “willing buyer and willing seller” of the fair market value standard are hypothetical investors. One court describes them as follows:

The statute, regulations, and precedents fix certain characteristics of the willing buyer and willing seller as a matter of law. They are persons who do not accept a formula as binding. To them, formulas are only tools. They do not overlook any relevant evidence. They weigh every relevant factor. They are not experts, but they are attentive to expert advice. They eschew legalism, but they weigh the import of legal rights. When performing their roles in a trial court, these hypothetical persons accept as binding the advice the trial judge gives them about legal rights, subject of course to correction in a higher court. Finally, for them, no negotiation is too difficult. They always arrive at a price the buyer willingly pays and the seller willingly accepts.⁵

Revenue Ruling 59-60 also states that “[c]ourt decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.”⁶

The willing seller and willing buyer should not be confused with the actual owner or recipient of the property:

[T]he “willing seller” is a hypothetical seller rather than the particular estate. Thus, the willing seller should not be identified with the decedent, and the decedent’s stock should not be included as part of a family unit for valuation purposes. Nor was it proper . . . to place any weight upon the identity of the

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parties that actually received the stock after distribution from the estate. For purposes of valuation, one should construct a hypothetical sale from a hypothetical willing seller to a similarly hypothetical willing buyer.\(^7\)

In other words, fair market value is to be determined by objective standards, not the characteristics or desires of a particular buyer or seller. The “willing buyer–willing seller rule presumes that the potential transaction is to be analyzed from the viewpoint of a hypothetical buyer whose only goal is to maximize his advantage.”\(^8\) At the same time, the valuation must consider the position of the willing seller, who would not sell the property at a price that did not also maximize his or her economic position.\(^9\)

Revenue Ruling 59-60 also emphasizes objective economic measures of fair market value. By definition, no market exists for closely held equity interests in which the informed investing public can reach a consensus as to value. When no such market exists, “the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.”\(^10\) These prices will primarily reflect the economic interests of investors who are outside the management of the business.

Fair market value is often the standard for valuations in divorce, but the definition and interpretation of this standard varies from state to state. In Wisconsin, fair market value is defined as “the price that property will bring when offered for sale by one who desires but is not obligated to sell and bought by one who is willing but not obligated to buy.”\(^11\)

This definition of fair market value is similar to the definition of fair market value for purposes of federal gift and estate taxes discussed above. This definition also views the buyer and seller as hypothetical individuals

\(^7\) Estate of Andrews v. Commissioner, 79 T.C. 938, 954–55 (1982). However, the government conceded on family attribution and allowed appropriate minority discounts for gifts to family members in Revenue Ruling 93-12, 1993-1 C.B. 202.

\(^8\) Estate of Curry v. United States, 706 F.2d 1424, 1428 (7th Cir. 1983); see also, e.g., Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981), Rev. Rul. 59-60, 1959-1 C.B. 237.


\(^11\) Liddle v. Liddle, 140 Wis. 2d 132, 138, 410 N.W.2d 196 (Ct. App. 1987).
and “requires consideration of what factors buyers and sellers find relevant when negotiating a deal.” 12 As in valuations for tax purposes, “all factors which have a bearing on the value of property must be considered to determine its fair market value.” 13

**B. [§ 9.3.8] Fair Value**

*Fair value* is a court-determined value, generally provided by statute. In certain states, if a corporation agrees to a merger, sale, or other action, and the minority stockholders believe they will not receive adequate consideration for their ownership interest, they have the right to have their shares valued and to receive the fair value for their shares. Legal input is needed when performing a fair value assignment to make certain that the specific state’s interpretation of fair value is applied.

Sections 180.1301–.1331 of the Wisconsin Statutes 14 describes a dissenter’s rights in Wisconsin and the purchase of the stockholder’s interest in a corporation. Section 180.1301(4) describes fair value as follows:

“Fair value”, with respect to a dissenter’s shares other than in a business combination, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable. “Fair value”, with respect to a dissenter’s shares in a business combination, means market value, as defined in [section] 180.1130 (9)(a) 1 to 4.

Under section 180.1130(9)(a)4., if there is no public trading price available, then market value is “the fair market value as determined in good faith by the board of directors of the resident domestic corporation.” 15

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12 Id.

13 Id. at 146.

14 Unless otherwise indicated, all references in this chapter to the Wisconsin Statutes are to the 2005-06 Wisconsin Statutes, as affected by acts through 2007 Wisconsin Act 14. Textual references to the Wisconsin Statutes are hereinafter indicated as “chapter xxx” or “section xxx.xx,” without the designation “of the Wisconsin Statutes.”

15 See also HMO-W Inc. v. SSM Health Care Sys., 2000 WI 46, 234 Wis. 2d 707, 611 N.W.2d 250.
C. [§ 9.3.9] Other Types of Value

*Investment value* is the value of an asset, business enterprise, or business interest as it relates to a specific buyer or seller and a specific set of circumstances. It differs from fair market value because of its emphasis on specifically characterized individuals and their unique motivations and synergies that are inapplicable to the hypothetical buyer.

*Intrinsic value* is similar to investment value, but is based on an analyst’s conclusions of value for the investing public rather than the attributes of a specific buyer or seller. Intrinsic value is sometimes referred to as *fundamental value*, and it is often the basis for a stockbroker’s recommendation.

*Liquidation value* assumes that a business’s operations cease and its individual assets are sold. Liquidation value is further defined to be either an *orderly liquidation* or a *forced liquidation*. An orderly liquidation implies that the assets are sold over a period of time that allows for the highest price to be recognized for each asset. Forced liquidation assumes that the assets are sold as quickly as possible, such as at an auction.

*Book value* is an accounting term that refers to an asset’s historical cost, reduced by any allowances for unrealized losses or depreciation, impairment, and amortization. Book value, as it relates to a company, refers to *owners’ equity*, or the difference between total assets and total liabilities as reported on the balance sheet. The book value of a company’s equity is often much different from the fair market value of that company’s equity.

V. [§ 9.3.10] The Valuation Process

A. [§ 9.3.11] In General

In addition to determining the type of value to be placed on a business, business valuation also requires gathering and analyzing financial, legal, economic, and market and industry information about a business enterprise.

Key to a business valuation is the analysis done to support the conclusion as to value. The purpose of the valuation often indicates the depth of the analysis required, the risks involved, and the budget needed to complete the valuation. For example, the due diligence analysis undertaken to complete an actual sale transaction is usually broader than the analysis undertaken to support an opinion of fair market value for tax purposes.
Some valuations are done after a transaction has been completed. In these instances, the information gathered should be limited to what was available or foreseeable as of the valuation date.16

A business enterprise is dynamic and changes over time. It is affected not only by its internal operations, but also by economic conditions, industry trends, and other external factors, and the valuation should indicate how these factors affect the value of the business enterprise. The goal is to identify the critical variables—the *value drivers*—and to assess the riskiness of an investment in the business. For example, what is the demand for the business’s products? What is the potential for substitute products? Is the industry cyclical? Is the industry mature? What are the barriers to entry? What are current economic conditions and trends, and how do they affect the business and its outlook?

What drives value will differ from business to business. Because financial statements only reflect the historical utilization of the business enterprise’s capacity to produce profits, each business should be analyzed to understand both the company’s capacity and the utilization of this capacity. This analysis can identify growth opportunities, as well as potential future risks for the business, that would not otherwise be reflected in the historical financial information.

**B. [§ 9.3.12] Adjustments**

*Normalization adjustments* are important to business valuation engagements. The purpose of a normalization adjustment is to determine what operations might have looked like under normal conditions, or what a prospective buyer might reasonably expect to obtain from the company in the future, using history as a guide. The type of ownership interest, type of entity, definition of value, and purpose of the valuation also may determine the nature of certain normalization adjustments.

Common normalization adjustments to closely held companies’ balance sheets include the removal and separate valuation of nonoperating or excess assets, such as an investment portfolio, receivables from owners, or assets used personally by the business’s owners.

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16 For a discussion of considering subsequent events in a valuation, see *Okerlund v. United States*, 365 F.3d 1044 (Fed. Cir. 2004).
Common adjustments to the company’s income statement include income and expenses related to nonoperating assets and liabilities, compensation and fringe benefits paid to owners or family members that are not at market, and nonrecurring income and expenses such as sales from one-time orders or the costs of unusual litigation.

C. [§ 9.3.13] Business Plans

Although few businesses have a current, written business plan ready for review, owners and managers typically have a clear idea of where the company is going and can articulate this to the appraiser. The valuation should reflect the enterprise’s current business plan unless there is clear evidence that the business plan will change. The assumed continuation of the current business plan is particularly important in the valuation of a minority ownership interest in a business, since a minority owner lacks the voting power to change the business plan of the controlling owners.17

D. [§ 9.3.14] Business Valuation Approaches and Methods

1. [§ 9.3.15] In General

The various business valuation methods are generally described as asset, market, and income approaches to value. These valuation approaches and methods can be used to determine the value of the entire business enterprise or an ownership interest in the business enterprise.

2. [§ 9.3.16] Asset Approach

The asset approach looks to the value of the net tangible and intangible assets committed to the business enterprise, and to adjustments made under different scenarios to reflect their fair market values.

A company’s assets and liabilities are stated on its financial statement at their book value, which is generally based on historical cost or historical cost less accumulated depreciation. The book value of an asset often bears no relationship to its current fair market value. Assets likely to be most

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17 See, e.g., Dunn v. Commissioner, 301 F.3d 339, 353 & n.25 (5th Cir. 2002).
undervalued on the balance sheet are fixed assets, such as real estate or equipment, and intangible assets, such as intellectual property.

The asset approach is most applicable in valuing a controlling ownership interests in businesses with significant tangible assets, such as holding companies, family limited partnerships, and investment companies. The asset approach is of limited use when applied to appraisals of intangibles, particularly goodwill, service businesses with few tangible assets, and minority ownership interests.\textsuperscript{18}

Two key valuation methods that exist within the asset approach are the \textit{adjusted book value} method and the \textit{orderly liquidation} method.

The \textit{adjusted book value} asset valuation method determines the value of a business enterprise by estimating the dollar amount needed to reproduce (either replace new or reproduce in their current condition) a business’s assets and liabilities. In this approach to value, while a consistent standard of “reproduction” must be used, it should be recognized that certain assets would not be replaced with outdated or inefficient buildings or equipment if the business were actually re-created. In addition, it is often difficult to estimate the value of a closely held business’s intangible assets separate from the profits the business earns.

The \textit{orderly liquidation} asset valuation method determines the value of the equity interest in a business enterprise from the dollar amount realized from the sale of the business enterprise’s assets in an orderly manner (not necessarily an auction) followed by payment of all business debt. This valuation method assumes that the business will not continue as an on-going operation, which usually means that any intangible value associated with the business may be lost unless it can be sold or transferred to others for value.


The \textit{market approach} assumes that value can be estimated from analyzing recent sales of comparable assets. In business valuations, the appraiser analyzes guideline public companies (as well as private companies, when possible) and guideline transactions to determine a

\textsuperscript{18} A minority owner lacks the necessary decision-making or voting power needed to force liquidation of the business enterprise to realize the value of the business’s net assets.
company’s value. This approach requires a thorough search for guideline companies and thorough analysis and adjustment of the guideline data, both public and private. The appraiser must also identify any prior transactions that may have occurred within the subject company, such as sales of stock.

The importance of the publicly traded guideline companies valuation method to the valuation of a closely held business depends on the comparability of the public companies to the closely held business being valued. In many instances, public companies are quite different from closely held businesses, because of factors such as federal regulation and compliance costs and the lack of personal guarantees of debt. Although this method may not be given much weight in the final value conclusion regarding a closely held equity interest, it can be a useful check on the reasonableness of the values determined from the other valuation methods.

Methods using the market approach include value multiples taken from guideline public company data and value multiples involving guideline transactions.

The publicly traded guideline companies market valuation method determines the value of the equity in a business enterprise by applying to financial data of the business being valued pricing information obtained from stocks of public companies that provide a reasonable basis for comparison to the business being valued. In their application, the pricing ratios obtained may have to be adjusted to account for the many differences (e.g., size, diversification, and management depth) between the public companies and the subject company. Because the public company pricing information is based on the trading prices of equity (stock) interests only, the value determined using this method is the publicly traded minority equivalent value of 100% of the equity in the business enterprise, i.e., priced as if it also were traded on the public market as a series of minority blocks of stock. This indicated value is then adjusted to reflect the business’s status as a closely held business enterprise. Because the value determined incorporates the public stocks’ minority status, a premium may need to be applied to the minority value to determine the value of a controlling ownership interest.

The mergers and acquisitions market valuation method determines value by applying pricing information obtained from transfers of entire business enterprises in an acquisition or merger. To be most effective, however, this valuation method would ideally have sufficient, reliable, publicly available information regarding recent merger and acquisition data for companies similar to the business enterprise being valued. In addition, pricing
information obtained from mergers and acquisitions should be carefully analyzed to determine whether the price includes a premium for synergies or other benefits that would not arise in a sale of the business being valued. This would occur when the valuation assumes that the business will remain an independent, closely held business.

The prior transactions market valuation method estimates value by applying pricing information from recent transfers of interests in the business being valued, possibly adjusted for changed circumstances since the transaction. This method may also consider pricing information from transactions that have not yet occurred, such as the price agreed to by the business owners for purposes of buy-sell agreements or purchase options. The appropriateness of this valuation method depends on whether the circumstances and the definition of value are similar and whether the prior transaction reflected arm’s-length negotiations.

4. [§ 9.3.18] Income Approach

Under the income approach, the appraiser estimates the future ownership benefits (earnings or cash flow to the business or to the shareholders) and discounts those benefits to present value using a rate suitable for the risks associated with realizing those benefits in light of alternative investment opportunities.

When applying this approach, the appraiser should identify whose business plan will be projected—the seller’s continuing business plan, the buyer’s business plan, or possibly a combination of both? Considering changes to the current business plan is important if the buyer will have sufficient voting power to implement these changes.

Methods using the income approach most commonly include discounted future cash flow and capitalization of earnings.

The discounted future cash flow income valuation method determines the value of a business enterprise by projecting the expected cash flows either to debt and equity holders or only to equity during the investment period, using a discount rate that can be either the business enterprise’s weighted average cost of capital (WACC) or the discount rate for equity only.
The WACC reflects

1. The cost of equity for an investment in the business enterprise (the opportunity cost of capital for the investor), which in turn reflects
   a. the risk-free rate of return available to investors in U.S. Treasury obligations;
   b. the additional rate of return required by investors in minority blocks of stocks of publicly traded companies; and
   c. the additional rate of return required by the particular risks associated with the business enterprise being valued;

2. The cost to the business of long-term, interest-bearing debt capital, which is the rate of return creditors require for supplying nonrecourse credit to the business enterprise; and

3. The appropriate mix, or weight, of the market values of equity capital and long-term debt capital that together make up the capital structure of the business enterprise.

If the costs of equity and debt are based on references to public companies, the value determined under the discounted cash flow valuation method is the publicly traded minority equivalent value of 100% of the business enterprise. Subtraction of the total amount of interest-bearing debt from the business enterprise value produces the publicly traded minority equivalent value of 100% of the equity in the business enterprise, i.e., priced as if it were traded on the public market as a series of minority blocks of stock. The equity value determined may have to be adjusted to reflect the closely held status of the business being valued, or the valuation of a controlling ownership interest in the business rather than a minority interest.

Alternatively, the appraiser may first adjust the discount rate to reflect the rate of return required by an investor in a closely held enterprise, whether on a controlling or a minority basis. Under this approach, the appraiser makes no further adjustment to the equity value to reflect its closely held status or controlling ownership position because these factors are already reflected in the discount rate.

Of all the valuation methods, the discounted cash flow valuation method demands the most disciplined and detailed projected assumptions for a business enterprise. It is also most sensitive to the predicted changes in a business’s operations during the projection period. Business buyers often
rely on this valuation method, but because it relies on projections of future performance, some courts have rejected values based on the discounted cash flow valuation method as being too speculative.

The capitalization of earnings income valuation method determines value by applying a multiple to the subject business enterprise’s established earnings base. Unlike the discounted cash flow valuation method, which projects year-to-year earnings growth, the capitalization of earnings income valuation method incorporates earnings growth into the capitalization multiple. The capitalization of earnings method is most appropriate when the subject company’s future operations are not expected to change significantly from its current normalized operations, or when current earnings are expected to grow at a somewhat predictable and steady rate.

The multiple applied to the earnings base reflects

1. The risk-free rate of return available to investors in United States Treasury obligations;

2. The additional rate of return required by investors in minority blocks of stocks of publicly traded companies;

3. The additional rate of return required by the particular risks associated with the business enterprise being valued; and

4. The expected growth rate in the business enterprise’s future earnings.

If the earnings base is the business’s income after taxes and the multiple reflects required rates of return on publicly traded stocks, then the value determined is the publicly traded minority equivalent value of the equity in the business. If the earnings base is the business’s earnings before interest and taxes, then the earnings multiple must be adjusted to reflect the business’s cost of debt. In this instance, the weighted average cost of capital is the basis for the multiple, and the value determined is the value of 100% of the business enterprise. Subtracting the total amount of interest-bearing debt from the business enterprise value produces the publicly traded minority equivalent value of 100% of the equity in the business enterprise; i.e., priced as if it were traded on the public market as a series of minority blocks of stock. The equity values determined from either earnings base may have to be adjusted downward to reflect the closely held status of the business being valued, or upward to reflect the valuation of a controlling

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19 See the discussion and calculation of this amount, supra, in the discussion of the discounted future cash flow valuation method.
ownership interest in the business rather than a minority interest. Alternatively, the appraiser may first adjust the earnings multiple to reflect the rate of return required by an investor in a closely held enterprise, whether on a controlling or a minority basis. Under this approach, the appraiser then makes no further adjustment to the equity value to reflect its closely held status or controlling ownership position because these factors are already reflected in the earnings multiple.

The capitalization of earnings valuation method is a simplified version of the discounted cash flow valuation method. Whereas the discounted cash flow valuation method reflects changes in annual cash flows and earnings during the projection period, the capitalization of earnings valuation method assumes that the only change in cash flows and resulting earnings base is growth at a constant annual rate.

5. [§ 9.3.19] Rules of Thumb

Business owners and appraisers may also apply certain rules of thumb as indicators of value or for purposes of providing quick estimates to assist in valuation discussions. Rules of thumb are formulas that sometimes are used to value companies in certain industries (e.g., an accounting practice is “worth” one times its annual revenues). This valuation method has limitations, however.

First, a rule of thumb is assumed to apply to the valuation of the typical business, yet there is no “typical” business.

Also, while rules of thumb derive from actual transactions, it is difficult to determine the motivations, actual pricing considerations, and payment terms agreed to in an actual transaction, and whether the same pricing multiples would apply to a particular company being valued.

With these limitations in mind, an appraiser may use rules of thumb as a test of reasonableness to compare to other value conclusions, but rules of thumb are not generally relied on as a primary valuation method.
VI. [§ 9.3.20] Allocating Business Enterprise Value to Specific Ownership Interests

The value of the business enterprise is sometimes referred to as the *market value of invested capital*, which is the sum of the market values of the interest-bearing debt and the equity committed to the business activity. Subtracting the market value of the debt from the business enterprise value yields the market value of the equity in the business. It is typically the equity, or ownership interest, value that is the focus of a business valuation.

If an individual owns 100% of the securities of a business enterprise, each share of ownership is usually assigned a pro rata portion of the total equity value of the business enterprise. If the business enterprise is owned by a number of individuals, however, each owner’s interest may carry a very different proportionate value. As the diagram below illustrates, the value of a block of securities in a business enterprise depends on the influence that block of securities has in the operations of the total business enterprise.

### Block Ranking Chart for Blocks of Stock In a Closely Held Corporation

(A Generalization)

Relative value attributed to various sizes of ownership interests in a closely held business enterprise, assuming only one equity ownership class outstanding and no restrictive or protective agreements governing ownership of these equity interests.

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<th>Highest Share Value</th>
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</table>
C  **51% to 80% block:** possessing substantial control, yet lacking a few of the income tax and legal rights; able to elect the board of directors and officers, set salaries, hire, fire, expand or contract business activities, declare dividends, and redeem or issue ownership interests.

D  **50% block with more than one equity holder owning other 50%:** possessing at least negative control, able to block but not to initiate action; potentially able to join with one or more other equity holders to assert substantial control.

E  **50% block with only one other equity holder:** possessing negative control with high risk of a deadlock.

F  **49% or smaller block but relatively large compared to other block(s) and no one block over 50%:** possessing potential leadership power through assembly of other equity holders with sufficient vote to gain group control or to dominate business affairs because of wide dispersal of other interests among satisfied or disinterested equity holders, thus gaining effective control with this block.

G  **Small block among many small blocks:** not a dominant block but not dominated by other blocks; management may hold significant control over such disorganized equity holders.

H  **Small block dominated by large block(s) with clear control:** a dominated block, at the mercy of those in control.

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**Lowest Share Value**

The particular securities being valued must be thoroughly analyzed, because the value of a specific ownership interest in a business enterprise reflects the rights of, and restrictions on, the securities. The analysis of the security must consider such factors as the following:

1. The voting rights of the security relating to such matters as
   a. declaring cash dividends;
   b. electing directors and officers;
   c. selling or reorganizing the business enterprise or its assets;
d. hiring, firing, and setting salaries;
e. setting general business policies; and
f. making certain tax elections, such as S corporation income tax status;

2. The preference rights over other classes of securities relating to
   a. distribution of cash dividends from earnings;
   b. distribution of liquidation proceeds; and
   c. voting rights; and

3. The transfer rights or restrictions reflected in
   a. buy-sell agreements with the business enterprise or other stockholders that restrict the free transfer of the securities, establish a set price for the securities if certain events occur, or provide “come along–take along rights” to shareholders if the business is sold; 20
   b. call options held by the corporation or other stockholders to buy the owner’s stock at a set price if certain events occur; and
   c. puts held by the owner that protect the value of the stock by allowing the stockholder to sell the stock at a set price if certain events occur.

VII. [§ 9.3.21] Discounts and Premiums

The value of a specific ownership interest in a business enterprise often reflects a discount or premium. Each valuation, however, must consider the appropriateness of any discount or premium.

I.R.S. Revenue Ruling 59-60 states that,

[a]lthough it is true that a minority interest in an unlisted corporation’s stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.21

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20 For a lengthy, but thorough, discussion of the effect of buy-sell agreements on gift and estate tax values, see Estate of True v. Commissioner, 82 T.C.M. (CCH) 27 (2001) (unpublished), aff’d, 390 F.3d 1210 (10th Cir. 2004).

21 Rev. Rul. 59-60, § 4.02(g), 1959-1 C.B. 237.
All adjustments in value, however, imply that there is first a value for the business interest that does not already incorporate the reason for subsequent adjustment.

The very words premium and discount . . . are somewhat misleading when applied to shares of closely held corporations. For example, when used in the conventional sense, “discount” implies the existence of a list price from which the discount is subtracted. Similarly, “premium” suggests a standard price to which the premium is added in determining the sale price. Applying these terms to control and noncontrol blocks of stock seems to imply that, between the discount and the premium share prices, an “intrinsic” price exists from which the discount price is taken and to which the premium is added. But there is in reality no such price. It is at best only a theoretical construct which has its origins in a linguistic confusion, resulting from the fact that these terms are only roughly applicable to the situation at hand. In fact, there are only differing degrees of control; when control is entirely absent, there is only its absence.22

Any discussion of premiums or discounts for an ownership interest must begin with a clear understanding of the initial value to which the premium or discount is applied:

There is no intrinsic price midway between the discount and premium since one merely describes the absence of the other. A minority discount, then, is a corollary of a majority premium and depends on the latter for its validity. A discount for lack of control is only appropriate if the amount discounted already includes a majority premium. This relationship is seldom recognized by courts in valuing stock of closely held corporations. Frequently, for example, courts permit a minority discount without finding that the value from which the discount was subtracted included a control premium. . . .

. . . .

Of course, investment value can be determined either by assuming control and then reducing that figure when valuing a minority interest or by assuming no control and increasing the determined value when valuing a majority interest. Whichever process is adopted, however, the control assumption must be consistent: A majority premium should not be applied if the value of the company is determined by assuming control and a minority discount should not be applied if the value of the company is determined by assuming no control.23

A control premium may be appropriate to recognize the economic benefits associated with voting control of a business.


23 Id. at 909–10, 913 (footnote omitted).
Control of a corporation is valuable because of the rights the controlling interest can exercise. “Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation’s capital structure, and decide whether to liquidate, merge, or sell assets.”

Control must be real, however:

Having a substantial or even the largest block of stock does not necessarily create effective control . . . . Participating in corporate decisions is a right that any stock interest may enjoy . . . but unless that interest controls (which in a closely held corporation typically means a majority interest), a control premium is unsupportable.

The subject of the valuation, and the valuation method applied, may indicate that a control premium is appropriate. For example, value determined using the publicly traded guideline companies valuation method generally results in a publicly traded minority equivalent value. If the subject of the valuation is a controlling interest in the business, then the appraiser must determine whether to add a control premium to the value. Any control premium, however, must be associated with the incremental economic benefit that the controlling owner can realize. The appraiser must also consider whether the basis for valuation, such as an adjusted cash flow, already incorporates elements of control. For example, adjustments to reported expenses for excess compensation or above-market rent are changes that only a controlling owner could make; therefore, no additional control premium is justified.

The amount of the control premium depends on the facts of each case—there is no specific amount that applies to every case. Acquisitions of one public company by another public company provide some insight into the value of control by comparing stock prices before the announced acquisition and the acquisition price, but these transaction prices typically include value assigned to elements other than pure control, such as the value of gaining market share or eliminating competition. Prices offered to take


25 Id. at 252.

26 See, e.g., Estate of Simplot v. Commissioner, 249 F.3d 1191, 1195 (9th Cir. 2001); Estate of Godley v. Commissioner, 286 F.3d 210, 216 (4th Cir. 2002).

27 See, e.g., Estate of Mitchell v. Commissioner, 250 F.3d 696 (9th Cir. 2001).
a public company private provide additional insight into the value of control, but usually without the benefits of any business combination.

Whether any premium should be added to reflect an ownership interest’s swing position among other interests is unclear. Arguing that a swing position—e.g., a small block of stock that could deliver voting control to one of two competing blocks of stock, neither of which now has voting control—carries additional value should not be a variation of the family attribution argument, which is contrary to the willing seller–willing buyer standard. On the other hand, the hypothetical sale cannot ignore actual facts that affect the value of the property being valued.

[B]asing value on assumptions concerning the identity of the parties or on findings about the intent of the parties as to how they will deal with their respective interests would be inappropriate. It is appropriate, however, to take into account all legal interests in a corporation . . . as those interests bear upon the practical likelihood and the effect on value . . . of the future exercise of options legitimately available to the owners of various interests.28

Discounts in value are often applied to account for a number of closely held business interest characteristics, such as the interest’s lack of a public market or an owner’s minority position in the business enterprise. All discounts, however, must be carefully defined and applied.

Closely held business interests are fundamentally different from stock actively traded in a public market: “In short, a publicly traded stock and a privately traded stock are not . . . the same animal distinguished only by the size, frequency, or color of its spots. The essential nature of the beast is different.”29

The rationale for allowing a discount in value for lack of marketability from the publicly traded equivalent value is that either the risks of illiquidity must be accepted or costs must be incurred in going public. To account for this lack of market liquidity and to overcome the advantages of investing in the public market, a discount should be applied to any per-share price determined by references to the public stock market.

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Discounts based on the cost of creating a public market for the business interest may overvalue small blocks of stock because the proportionate legal, accounting, marketing, and other costs of creating a market for the small block of stock would be prohibitively high. Studies comparing prices paid for closely held stocks with the prices of those stocks once the company went public indicate that private sales took place at a median discount of 40–45% from the public offering price for similar stock during the period 1985 to 2000.\(^{30}\)

The amount of the discount for lack of marketability accepted by courts in federal estate and gift tax cases varies from case to case, but the amount of the discount should relate to a specific analysis of the business enterprise and ownership interest being valued. *Mandelbaum v. Commissioner*\(^{31}\) identifies specific factors to consider in establishing the discount for lack of marketability:

1. Discounts applied to public stocks whose transfer is restricted (see, for example, restricted stock and initial public offering (IPO) studies of discounts for lack of marketability);

2. Quality of financial information for the company (including the strength of the company as revealed by analysis of its financial statements and the quality of the financial statements for the company, such as audited statements);

3. The company’s dividend policy, and

   whether an investor will receive a fair return on his or her investment. The fact that a company pays small or no dividends will not always negatively affect the company’s marketability.

   Even if a corporation seldom pays dividends, an investor may aim to participate in the corporation’s success mainly through the appreciation in the value of his or her stock brought on by retained earnings and the possibility of a future return.\(^{32}\)

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\(^{32}\) *Id.* (citation omitted).
4. Nature of the company, its history, its position in the industry, and its economic outlook;

5. The strength of the company’s management and whether it has acted to promote the interest of all, or only a few, shareholders;

6. The amount of control represented by the block of stock being valued;

7. Restrictions on the transferability of the stock, and whether such transfer restrictions indicate a specific value for the stock, such as a formula price at which the company may exercise its option to purchase the stock;

8. The length of time the investor must hold his or her investment in order to reap a sufficient profit—“[m]arket risk tends to increase (and marketability tends to decrease) as the holding period gets longer”;

9. The company’s stock redemption policy and its history of prior redemptions, which may indicate that the company may be willing to make future redemptions, reducing the risk of lack of marketability; and

10. The costs associated with making a public offering of the stock, including whether the individual investor must bear the full burden of such costs (as opposed to participating in a company-wide public offering).

A discount for lack of marketability may be reduced for a closely held interest if a non-public market exists for the stock. “[U]nder the law, the applicable market in which the hypothetical willing buyer may be found need not be one which includes the general public. It is sufficient if there are potential buyers among those closely connected with the corporation.”

In *Luce v. United States*, other stock had been bought from stockholders because it was the controlling stockholders’ policy to keep the stock of the corporation within family or management ownership. As a result, the court allowed no discount for lack of marketability.

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34 4 Cl. Ct. 212 (1983).

35 *Id. But see Estate of Neff v. Commissioner*, 57 T.C.M. (CCH) 669 (1989) (small discount for lack of marketability was allowed even though company created a market for closely held stock).
Some court opinions do not specifically separate discounts for minority positions from discounts for lack of marketability. Instead, the court applies one discount that combines both factors.

Courts have long recognized that the shares of stock of a corporation that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation or a 100 percent ownership interest in a company. The minority discount is recognized because the holder of a minority interest lacks control over corporate policy, cannot direct the payment of dividends, and cannot compel a liquidation of corporate assets.36

Stock values indicated by reference to publicly traded securities generally should not be further discounted for a minority position, however, because the prices of the publicly traded stocks already reflect a minority position in a business.

A minority discount may not always apply to a minority interest. In HMO-W Inc.,37 the court held that minority discounts were not applicable in determining the fair value of dissenters’ shares in an appraisal proceeding. Instead, the dissenting minority shareholder in that case was awarded its proportionate share of the going concern value of the entire company. (The case did not directly address the issue of a discount for lack of marketability.)

There are other considerations that may warrant a premium to, or a discount from, the per-share value established for the business as a whole, such as:

1. Restrictive agreements applicable at the death of an owner, if
   a. the price for the business interest is fixed or determinable by a formula;
   b. the decedent’s estate is obliged to sell at death, whether mandatory or under an option to purchase;
   c. the obligation to sell is binding during life as well as at death; and
   d. the agreement is a bona fide business arrangement;

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37 2000 WI 46, ¶¶ 30–31, 234 Wis. 2d 707.
2. Other agreements affecting transferability of business interests (e.g., partnership and buy-sell agreements) as evidence of value, but not always controlling as to value.\textsuperscript{38} The agreement may establish the monetary consequences to an owner who withdraws from the business, but this is only one indication of value;\textsuperscript{39}

3. Stock options and other future interests as a claim on the equity interests in the business;\textsuperscript{40}

4. Noncompete agreements that prevent a key employee from leaving the business and diverting future revenues and value or, in the alternative, the lack of such agreements, which puts future revenues and value at risk;\textsuperscript{41}

5. The loss of a key employee whose skills or relationships are important to the business, because the loss of the person would cause a decline in business revenues and value;

6. In some instances, the capital gains tax that would be triggered by the sale of appreciated assets.\textsuperscript{42} For divorce valuations, the likelihood of the asset’s sale often determines whether a discount for potential taxes is found to be appropriate by the court;\textsuperscript{43} or

7. Unaudited or poor financial statements.

\textsuperscript{38} \textit{Ondrasek v. Ondrasek}, 126 Wis. 2d 469, 475, 377 N.W.2d 190 (Ct. App. 1985).

\textsuperscript{39} \textit{Sharon v. Sharon}, 178 Wis. 2d 481, 489, 504 N.W.2d 415 (Ct. App. 1993).

\textsuperscript{40} \textit{See, e.g., Chen v. Chen}, 142 Wis. 2d 7, 416 N.W.2d 661 (Ct. App. 1987).

\textsuperscript{41} \textit{Sommerfield v. Sommerfield}, 154 Wis. 2d 840, 454 N.W.2d 55 (Ct. App. 1990).


\textsuperscript{43} \textit{See, e.g., Ondrasek}, 126 Wis. 2d at 480–81.
VIII. [§ 9.3.22] Any Valuation Must Be Based on the Facts Known to the Willing Buyer and Willing Seller as of the Valuation Date

In *Ithaca Trust Co. v. United States*, Justice Holmes stated that:

> The question is whether the amount of the diminution, that is, the length of the postponement, is to be determined by the event as it turned out, of the widow’s death within six months, or by mortality tables showing the probabilities as they stood on the day when the testator died. The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. . . . . Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true. Tempting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done, but that the value of the wife’s life interest must be estimated by the mortality tables.

In *Estate of Gilford v. Commissioner*, the court stated that subsequent events could be considered only if there was a “reasonable and intelligent expectation” that such events would occur as of the valuation date.

IX. [§ 9.3.23] Reconciliation of Value Conclusions

The different valuation methods, along with the application of appropriate discounts and premiums, will likely result in different values for a business interest. If more than one value has been calculated, the appraiser must then reconcile these values and determine a final conclusion of value for the business interest. In general, the more appropriate a valuation method is for a given company, the more weight the resulting value should be given in determining the final value conclusion.

A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and

44 279 U.S. 151, 155 (1929) (citation omitted).
45 88 T.C. 38, 52 (1987).
reasonableness must enter into the process of weighing those facts and determining their aggregate significance.46

When there are conflicting views between experts regarding the valuation of a closely held business interest, however, the court must give reasons for relying on one method over another.47 The court may conclude that the value of a closely held business interest lies somewhere between the values expressed by experts; the court must, however, support its decision with facts of record.48

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46 Rev. Rul. 59-60, § 3.01, 1959-1 C.B. 237. See also Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002), and Okerlund v. United States, 365 F.3d 1044 (Fed. Cir. 2004), regarding the weighting of values determined under different valuation methods.
