

Rev. Rul. 65-192

SECTION 1001. - DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

26 CFR 1.1001-1: Computation of gain or loss.

July, 1965

[*1]

The general approach, methods and factors outlined in Revenue Ruling 59-60, C.B. 1959-1, 237, for use in valuing closely-held corporate stocks for estate and gift tax purposes are equally applicable to valuations thereof for income and other tax purposes and also in determinations of the fair market values of business interests of any type and of intangible assets for all tax purposes.

The formula approach set forth in A.R.M. 34, C.B. 2, 31 (1920), and A.R.M. 68, C.B. 3, 43 (1920), has no valid application in determinations of the fair market values of corporate stocks or of business interests, unless it is necessary to value the intangible assets of the corporation or the intangible assets included in the business interest. The formula approach may be used in determining the fair market values of intangible assets only if there is no better basis therefor available. In applying the formula, the average earnings period and the capitalization rates are dependent upon the facts and circumstances pertinent thereto in such case.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to furnish information and guidance as to the usage to be made of suggested methods for determining [*2] the value as of March 1, 1913, or of any other date, of intangible assets and to identify those areas where a valuation formula set forth in A.R.M. 34, C.B. 2, 31 (1920), as modified by A.R.M. 68, C.B. 3, 43 (1920), both quoted in full below should and should not be applied. Since it appears that such formula has been applied to many valuation issues for which it was never intended, the Internal Revenue Service reindicates its limited application.

SEC. 2. BACKGROUND.

A.R.M. 34 was issued in 1920 for the purpose of providing suggested formulas for determining the amount of March 1, 1913, intangible asset value lost by breweries and

other businesses connected with the distilling industry, as a result of the passage of the 18th Amendment to the Constitution of the United States. A.R.M. 68 was issued later in 1926 the same year and contained a minor revision of the original ruling so that its third formula would be applied in accordance with its purpose and intent.

SEC. 3. STATEMENT OF POSITION.

.01 Although the formulas and approach contained in A.R.M. 34, were specifically aimed at the valuation of intangible assets of distilling and related companies as of March 1, 1913, [*3] the last two paragraphs of the ruling seemingly broaden it to make its third formula applicable to almost any kind of enterprise. The final sentences, however, limit the purpose of such formula by stating that "In * * * all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it, * * *, "and by providing certain checks and alternatives. Also, both A.R.M. 34 and A.R.M. 68 expressly stated that such formula was merely a rule for guidance and not controlling in the presence of "better evidence" in determining the value of intangible assets. Furthermore, T.B.R. 57, C.B. 1, 40 (1919), relating to the meaning of "fair market value" of property received in exchange for other property, which was published before A.R.M. 34 and A.R.M. 68 and has not been revoked, set forth general principles of valuation that are consistent with Revenue Ruling 59-60, C.B. 1959-1, 237. Moreover, in S.M. 1609, C.B. III-1, 48 (1924) it was stated that "The method suggested in A.R.M. 34 for determining the value of intangibles is * * * controlling only in the absence of better evidence." As said in North [*4] American Service Co., Inc. v. Commissioner, 33 T.C. 677, 694 (1960), acquiescence, C.B. 1960-2, 6, "an A.R.M. 34 computation would not be conclusive of the existence and value of good will if better evidence were available * * *."

.02 Revenue Ruling 59-60 sets forth the proper approach to use in the valuation of closely-held corporate stocks for estate and gift tax purposes. That ruling contains the statement that no formula can be devised that will be generally applicable to the multitude of different valuation issues. It also contains a discussion of intangible value in closely-held corporations and some of the elements which may support such value in a given business.

SEC. 4. DELINEATION OF AREAS IN WHICH SUGGESTED METHODS WILL BE EFFECTIVE.

.01 The general approach, methods, and factors outlined in Revenue Ruling 59-60 are equally applicable to valuations of corporate stocks for income and other tax purposes as well as for estate and gift tax purposes. They apply also to problems involving the determination of the fair market value of business interests of any type, including partnerships, proprietorships, etc., and of intangible assets for all tax purposes. [*5]

.02 Valuation, especially where earning power is an important factor, is in essence a process requiring the exercise of informed judgment and common sense. Thus, the suggested formula approach set forth in A.R.M. 34, has no valid application in

determinations of the fair market value of corporate stocks or of business interests unless it is necessary to value the intangible assets of the corporation or the intangible assets included in the business interest. The formula approach may be used in determining the fair market values of intangible 261 assets only if there is no better basis therefor available. In applying the formula, the average earnings period and the capitalization rates are dependent upon the facts and circumstances pertinent thereto in each case. See *John Q. Shunk et al. v. Commissioner*, 10 T.C. 293, 304-5 (1948), acquiescence, C.B. 1948-1, 3, affirmed 173 Fed. (2d) 747 (1949); *Ushco Manufacturing Co., Inc. v. Commissioner*, Tax Court Memorandum Opinion entered March 10, 1945, affirmed 175 Fed. (2d) 821 (1945); and *White & Wells Co. v. Commissioner*, 19 B.T.A. 416, nonacquiescence C.B. IX-2, 87 (1930), reversed and remanded 50 [*6] Fed. (2d) 120 (1931).

SEC. 5. QUOTATION OF A.R.M. 34.

For convenience, A.R.M. 34 reads as follows:

The Committee has considered the question of providing some practical formula for determining value as of March 1, 1913, or of any other date, which might be considered as applying to intangible assets, but finds itself unable to lay down any specific rule of guidance for determining the value of intangibles which would be applicable in all cases and under all circumstances. Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets such as good will, trade-marks, trade brands, etc. However, there are several methods of reaching a conclusion as to the value of intangibles which the Committee suggests may be utilized broadly in passing upon questions of valuation, not to be regarded as controlling, however, if better evidence is presented in any specific case.

Where deduction is claimed for obsolescence or loss of good will or trade-marks, the burden of proof is primarily upon the taxpayer to show the value of such good will or trade-marks [*7] on March 1, 1913. Of course, if good will or trade-marks have been acquired for cash or other valuable considerations subsequent to March 1, 1913, the measure of loss will be determined by the amount of cash or value of other considerations paid therefor, and no deduction will be allowed for the value of good will or trade-marks built up by the taxpayer since March 1, 1913. The following suggestions are made, therefore, merely as suggestions for checks upon the soundness and validity of the taxpayers' claims. No obsolescence or loss with respect to good will should be allowed except in cases of actual disposition of the asset or abandonment of the business.

In the first place, it is recognized that in numerous instances it has been the practice of distillers and wholesale liquor dealers to put out under well-known and popular brands only so much goods as could be marketed without affecting the established market price therefor and to sell other goods of the same identical manufacture, age, and character under other brands, or under no brand at all, at figures very much below those which the well-known brands commanded. In such cases the difference between the price at which

[*8] whisky was sold under a given brand name and also under another brand name, or under no brand, multiplied by the number of units sold during a given year gives an accurate determination of the amount of profit attributable to that brand during that year, and where this practice is continued for a long enough period to show that this amount was fairly constant and regular and might be expected to yield annually that average profit, by capitalizing this earning at the rate, say, of 20 per cent, the value of the brand is fairly well established.

Another method is to compare the volume of business done under the trade-mark or brand under consideration and profits made, or by the business whose good will is under consideration, with the similar volume of business and profit made in other cases where good will or trade-marks have been actually sold for cash, recognizing as the value of the first the same proportion of the selling price of the second, as the profits of the first attributable to brands or good will, is of the similar profits of the second.

The third method and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for [*9] the application of the preceding ones, is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10 per cent upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, 262 and it is the opinion of the Committee that this return should be capitalized upon the basis of not more than five years' purchase - that is to say, five times the amount available as return from intangibles should be the value of the intangibles.

In view of the hazards of the business, the changes in popular tastes, and the difficulties in preventing imitation or counterfeiting of popular brands affecting the sales of the genuine goods, the Committee is of the opinion that the figure given of 20 per cent return on intangibles is not unreasonable, and it recommends that no higher figure than that be attached in any case to intangibles without a very clear and adequate showing that the value of the intangibles was in fact greater than would be reached by applying this formula.

The foregoing is intended to apply particularly to businesses [*10] put out of existence by the prohibition law, but will be equally applicable so far as the third formula is concerned, to other businesses of a more or less hazardous nature. In the case, however, of valuation of good will of a business which consists of the manufacture or sale of standard articles of every-day necessity not subject to violent fluctuations and where the hazard is not so great, the Committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10 to 8 or 9 per cent, and that the percentage for capitalization of the return upon intangibles might be reduced from 20 to 15 per cent.

In any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1943, might reasonably have expected to receive from it, and therefore a representative period should be used for averaging actual earnings,

eliminating any year in which there were extraordinary factors affecting earnings either way. Also, in the case of the sale of good will of a going business the percentage rate of capitalization of earnings applicable to good will shown by the amount actually paid for the business [*11] should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon the basis of capitalization of earnings less than the figures above indicated as the ones ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.

SEC. 6. QUOTATION OF A.R.M. 68.

Also for convenience, A.R.M. 68 reads as follows:

The Committee is in receipt of a request for advice as to whether under A.R.M. 34 the 10 per cent upon tangible assets is to be applied only to the net tangible assets or to all tangible assets on the books of the corporation, regardless of any outstanding obligations.

The Committee, in the memorandum in question, undertook to lay down a rule for guidance in the absence of better evidence in determining the value as of March 1, 1913, of good will, and held that in determining such value, income over an average period in excess of an amount sufficient to return 10 per cent upon tangible assets should be capitalized at 20 per cent. Manifestly, since the effort is to determine the value of the good will, and therefore the true net worth of the taxpayer as of March 1, 1913, the 10 per cent [*12] should be applied only to the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable.

In other words, the purpose and intent are to provide for a return to the taxpayer of 10 per cent upon so much of his investment as is represented by tangible assets and to capitalize the excess of earnings over the amount necessary to provide such return, at 20 per cent.

SEC. 7. EFFECT ON OTHER DOCUMENTS.

Although the limited application of A.R.M. 34 and A.R.M. 68 is reindicated in this Revenue Ruling, the principles enunciated in those rulings are not thereby affected.