

Rev. Rul. 83-120

Section 2512. -- Valuation of Gifts

26 CFR 25.2512-2: Stocks and bonds.

(Also Sections 305, 351, 354, 368, 2031; 1.305-5, 1.351-1, 1.354-1, 1.368-1, 20.2031-2.)

July, 1983

[*1]

Valuation; stock; closely held business. The significant factors in deriving the fair market value of preferred and common stock received in certain corporate reorganizations are discussed. Rev. Rul. 59-60 amplified.

SECTION 1. PURPOSE

The purpose of this Revenue Ruling is to amplify Rev. Rul. 59-60, 1959-1 C.B. 237, by specifying additional factors to be considered in valuing common and preferred stock of a closely held corporation for gift tax and other purposes in a recapitalization of closely held businesses. This type of valuation problem frequently arises with respect to estate planning transactions wherein an individual receives preferred stock with a stated par value equal to all or a large portion of the fair market value of the individual's former stock interest in a corporation. The individual also receives common stock which is then transferred, usually as a gift, to a relative.

Sec. 2. BACKGROUND

.01 One of the frequent objectives of the type of transaction mentioned above is the transfer of the potential appreciation of an individual's stock interest in a corporation to relatives at a nominal or small gift tax cost. Achievement of this objective requires [*2] preferred stock having a fair market value equal to a large part of the fair market value of the individual's former stock interest and common stock having a nominal or small fair market value. The approach and factors described in this Revenue Ruling are directed toward ascertaining the true fair market value of the common and preferred stock and will usually result in the determination of a substantial fair market value for the common

stock and a fair market value for the preferred stock which is substantially less than its par value.

.02 The type of transaction referred to above can arise in many different contexts. Some examples are:

(a) A owns 100% of the common stock (the only outstanding stock) of Z Corporation which has a fair market value of 10,500x. In a recapitalization described in section 368(a)(1)(E), A receives preferred stock with a par value of 10,000x and new common stock, which A then transfers to A 's son B.

(b) A owns some of the common stock of Z Corporation (or the stock of several corporations) the fair market value of which stock is 10,500x. A transfers this stock to a new corporation X in exchange for preferred [*3] stock of X corporation with a par value of 10,000x and common stock of corporation, which A then transfers to A 's son B.

(c) A owns 80 shares and his son B owns 20 shares of the common stock (the only stock outstanding) of Z Corporation. In a recapitalization described in section 368(a)(1)(E), A exchanges his 80 shares of common stock for 80 shares of new preferred stock of Z Corporation with a par value of 10,000x. A 's common stock had a fair market value of 10,000x.

SEC. 3. GENERAL APPROACH TO VALUATION

Under section 25.2512-2(f)(2) of the Gift Tax Regulations, the fair market value of stock in a closely held corporation depends upon numerous factors, including the corporation's net worth, its prospective earning power, and its capacity to pay dividends. In addition, other relevant factors must be taken into account. See Rev. Rul. 59-60. The weight to be accorded any evidentiary factor depends on the circumstances of each case. See section 25.2512-2(f) of the Gift Tax Regulations.

SEC. 4. APPROACH TO VALUATION -- PREFERRED STOCK

.01 In general the most important factors to be considered in determining the value [*4] of preferred stock are its yield, dividend coverage and protection of its liquidation preference.

.02 Whether the yield of the preferred stock supports a valuation of the stock at par value depends in part on the adequacy of the dividend rate. The adequacy of the dividend rate should be determined by comparing its dividend rate with the dividend rate of high-grade publicly traded preferred stock. A lower yield than that of high-grade preferred stock indicates a preferred stock value of less than par. If the rate of interest charged by independent creditors to the corporation on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred stock should be correspondingly higher than the yield on high quality preferred stock. A yield which is not correspondingly higher reduces the value of the preferred stock. In addition,

whether the preferred stock has a fixed dividend rate and is nonparticipating influences the value of the preferred stock. A publicly traded preferred stock for a company having a similar business and similar assets with similar liquidation preferences, voting rights and other similar terms [*5] would be the ideal comparable for determining yield required in arms length transactions for closely held stock. Such ideal comparables will frequently not exist. In such circumstances, the most comparable publicly-traded issues should be selected for comparison and appropriate adjustments made for differing factors.

.03 The actual dividend rate on a preferred stock can be assumed to be its stated rate if the issuing corporation will be able to pay its stated dividends in a timely manner and will, in fact, pay such dividends. The risk that the corporation may be unable to timely pay the stated dividends on the preferred stock can be measured by the coverage of such stated dividends by the corporation's earnings. Coverage of the dividend is measured by the ratio of the sum of pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends. Standard & Poor's Ratings Guide, 58 (1979). Inadequate coverage exists where a decline in corporate profits would be likely to jeopardize the corporation's ability to pay dividends on the preferred stock. The ratio for the preferred stock in question should [*6] be compared with the ratios for high quality preferred stock to determine whether the preferred stock has adequate coverage. Prior earnings history is important in this determination. Inadequate coverage indicates that the value of preferred stock is lower than its par value. Moreover, the absence of a provision that preferred dividends are cumulative raises substantial questions concerning whether the stated dividend rate will, in fact, be paid. Accordingly, preferred stock with noncumulative dividend features will normally have a value substantially lower than a cumulative preferred stock with the same yield, liquidation preference and dividend coverage.

.04 Whether the issuing corporation will be able to pay the full liquidation preference at liquidation must be taken into account in determining fair market value. This risk can be measured by the protection afforded by the corporation's net assets. Such protection can be measured by the ratio of the excess of the current market value of the corporation's assets over its liabilities to the aggregate liquidation preference. The protection ratio should be compared with the ratios for high quality preferred stock to determine [*7] adequacy of coverage. Inadequate asset protection exists where any unforeseen business reverses would be likely to jeopardize the corporation's ability to pay the full liquidation preference to the holders of the preferred stock.

.05 Another factor to be considered in valuing the preferred stock is whether it has voting rights and, if so, whether the preferred stock has voting control. See, however, Section 5.02 below.

.06 Peculiar covenants or provisions of the preferred stock of a type not ordinarily found in publicly traded preferred stock should be carefully evaluated to determine the effects of such covenants on the value of the preferred stock. In general, if covenants would inhibit the marketability of the stock or the power of the holder to enforce dividend or

liquidation rights, such provisions will reduce the value of the preferred stock by comparison to the value of preferred stock not containing such covenants or provisions.

.07 Whether the preferred stock contains a redemption privilege is another factor to be considered in determining the value of the preferred stock. The value of a redemption privilege triggered by death of the preferred shareholder will [*8] not exceed the present value of the redemption premium payable at the preferred shareholder's death (i.e., the present value of the excess of the redemption price over the fair market value of the preferred stock upon its issuance). The value of the redemption privilege should be reduced to reflect any risk that the corporation may not possess sufficient assets to redeem its preferred stock at the stated redemption price. See. 03 above.

SEC. 5. APPROACH TO VALUATION -- COMMON STOCK

.01 If the preferred stock has a fixed rate of dividend and is nonparticipating, the common stock has the exclusive right to the benefits of future appreciation of the value of the corporation. This right is valuable and usually warrants a determination that the common stock has substantial value. The actual value of this right depends upon the corporation's past growth experience, the economic condition of the industry in which the corporation operates, and general economic conditions. The factor to be used in capitalizing the corporation's prospective earnings must be determined after an analysis of numerous factors concerning the corporation and the economy as a whole. See Rev. Rul. 59-60, [*9] at page 243. In addition, after-tax earnings of the corporation at the time the preferred stock is issued in excess of the stated dividends on the preferred stock will increase the value of the common stock. Furthermore, a corporate policy of reinvesting earnings will also increase the value of the common stock.

.02 A factor to be considered in determining the value of the common stock is whether the preferred stock also has voting rights. Voting rights of the preferred stock, especially if the preferred stock has voting control, could under certain circumstances increase the value of the preferred stock and reduce the value of the common stock. This factor may be reduced in significance where the rights of common stockholders as a class are protected under state law from actions by another class of shareholders, see *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), particularly where the common shareholders, as a class, are given the power to disapprove a proposal to allow preferred stock to be converted into common stock. See ABA-ALI Model Bus. Corp. Act, Section 60 (1969).

SEC. 6. EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 59-60, as modified by Rev. Rul. 65-193, [*10] 1965-2 C.B. 370 and as amplified by Rev. Rul. 77-287, 1977-2 C.B. 319, and Rev. Rul. 80-213, 1980-2 C.B. 101, is further amplified.