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VALUING THE STOCK OF CLOSELY HELD NEW HAMPSHIRE CORPORATIONS AND LLCs[1]

EXECUTIVE SUMMARY

There is no generally reliable method for valuing the stock of New Hampshire closely held corporations or LLCs. However, for both tax and legal purposes, the starting point should normally be an old but still highly authoritative Internal Revenue Service revenue ruling designated Rev. Rul. 59-60, 1959-1 C.B. 237. In addition, in appraising any business, there are also a small number of New Hampshire Supreme Court cases that New Hampshire business appraisers must take into account.

DISCUSSION

I. INTRODUCTION TO REV. RUL. 59-60; GENERAL CONSIDERATIONS UNDER THE RULING

New Hampshire CPAs, EAs and lawyers are often asked by their clients to assist them in determining the value of their companies and thus of ownership interests in these companies. These requests can arise in the context of gift or estate tax issues, in connection with buy-outs of deceased or retired business owners by remaining owners, in connection with sales of businesses to third parties, and in various other contexts. For all of these purposes, these professionals must take into account the key federal tax authorities and New Hampshire legal authorities.

The principal federal authority is Rev. Rul. 59-60. Although the IRS issued this ruling in order to provide guidance for gift and estate tax purposes, the ruling also provides valuable guidance for all other business valuation purposes. Rev. Rul. 59-60 is eight pages long, and every sentence in it requires careful consideration. However, for purposes of valuing New Hampshire closely held companies, the ruling can be viewed as reflecting three general principles and, in my view, 17 specific valuation factors. The three general principles are set forth below. The 17 factors are addressed in Part II of this newsletter. The relevant New Hampshire case law is briefly addressed in Part III.

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[1] I am grateful for the many useful ideas and authorities that I have obtained from the lawyers of McLane, Graf, Raulerson & Middleton, Professional Association, to which I am of counsel, in my writing of this newsletter. However, the views in this letter are not necessarily those of any other McLane lawyer, and I alone am responsible for an errors in the letter.

1. <u>Meaning of fair market value</u>. The fair market value of corporation stock and LLC membership rights (which I'll refer to jointly as "business ownership interests") means the price at which the interests would change hands between a willing buyer and a willing seller when (a) the former is not under any compulsion to buy; (b) the latter is not under any compulsion to sell; and (c) both parties have reasonable knowledge of the relevant facts. Regs. § 20-2031-1(b).

2. <u>Importance of objective data</u>. Any appraisal of business ownership interests should be based to the fullest possible extent on properly compiled financial statements and other objective data.

3. <u>No generally applicable formula</u>. Because the relevant facts vary so much from one business to another, there can be no generally applicable formula for valuing business ownership interests. Instead, the appraiser, in appraising the value of these interests, must ascertain and duly consider each of these facts and must apply not only informed judgment but also common sense and reasonableness.

4. <u>Risks</u>. Any valuation of a business must give due weight to the risks that are likely to confront the business presently and in the reasonably foreseeable future. These must include both risks to the business as such, risks relevant to the industry in which the business operates, and general economic risks.

5. <u>Capitalizations of earnings</u>. Many valuations of businesses are likely to involve a capitalization of reasonably foreseeable business net income. Just is there is no generally applicable formula for valuing businesses themselves, so too, there is no generally applicable formula for capitalizations of earnings.

6. <u>Unavoidable difficulty and uncertainty</u>. Because any such appraisal will require a prediction about future profits, the task will inevitably be difficult and the results uncertain and subject to varying opinions.

II. VALUATION FACTORS UNDER REV. RUL. 59-60

However, Rev. Rul. 59-60 identifies 17 specific factors (some of which are explicit in the ruling and others clearly implicit) that it defines as potentially important in defining the valuation of particular businesses and thus of ownership interests in these business. These factors are as follows:

Factor 1. <u>Nature of the business</u>. What is the nature of the business? For example, what various products and services does it provide to its customers?

Factor 2. <u>General economic conditions</u>. Which facts (if any) concerning the local or national economic situation are relevant in valuing the business?

Factor 3. <u>Economic outlook in relevant industry</u>. What is the economic outlook in the specific industry in which the business is involved?

Factor 4. <u>Book value of business ownership interests</u>. What is the book value of the business's business ownership interests?

Factor 5. History of business. What has the history of the business been since its formation? For example, over the years, have its lines of business changed significantly; and what have been the relevant trends in its profitability?

Factor 6. Financial condition of the business. What is the current financial condition of the business?

Factor 7. Earning capacity of the business. What is the earning capacity of the business?

Factor 8. Dividend-paying capacity of the business. What capacity does the business have to pay dividends?

Factor 9. Goodwill. Does the business itself have goodwill or other intangible value, or is the goodwill of the business more properly attributable to its individual owners?

Factor 10. Previous sales of interests in the business. Has the business previously sold any of its business ownership interests to any person? If so, what were the terms of each such sale?

Factor 11. Sales of interests in similar businesses. Have there been any sales of business ownership interests of similar businesses? If so, what have been the terms of these sales?

Factor 12. Competition. How strong are the current and possible future competitors of the business?

Factor 13. Effect of loss of managers, etc. Will the loss of any of the business's managers or employees—for example, the death of the business owner triggering the buy-out in question—be likely to adversely affect the value of the business? If so, to what extent will "key man" insurance or other factors be likely to offset this effect?

Factor 14. Classes of business ownership interests in the business. Does the business have more than one class of business ownership interests? If so, how do the legal characteristics of these various classes affect their value?

Factor 15. Control vs. minority. Do the specific business ownership interests that are the subject of the relevant buy-out provide for control of the company, or do they constitute a mere minority interest in it? In either case, what premium or discount should be applied to the interests in question?

Factor 16. Inter-owner agreements. Is there any agreement among the owners of the company that restricts the sale of business ownership interests in the company or that otherwise affects the value of these interests?

Factor 17. Relationship of parties to inter-owner agreements. Assuming that such an agreement exists, does the relationship among its parties—e.g., as, on the one hand, independent unrelated persons or, on the other, as members of the same family—affect its objectivity and thus its utility in valuing interests in the business?

In any valuation of a closely held business and of ownership interests in that business, one must begin by giving reasonable consideration to each of the above 17 factors. However, my experience is that in most such valuations:

- Many of these factors will prove to be irrelevant.
- Factors that are not addressed in Rev. Rul. 59-60 either expressly or even implicitly but that can be identified by diligent research and reflection concerning the business in question will often decide all significant valuation issues relating to the business.

Excellent comprehensive guidelines on the valuation of corporate stock may be found in Mezullo, 831-3rd T.M., Valuation of Corporate Stock.

III. KEY NEW HAMPSHIRE CASE LAW RELEVANT TO BUSINESS VALUATIONS

Important recent New Hampshire cases relevant to business valuations include *In the Matter of Watterworth & Watterworth*, 149 N.H. 442 (2003) and *Rattee v. Rattee*, 146, N.H. 44 (2001). It is important for appraisers of New Hampshire companies to be generally familiar with these cases, but in my view, both of them—and all other relevant New Hampshire cases—not only are entirely consistent with the Rev. Rul. 59-60 but also add nothing significant to the guidelines contained in that ruling.