Business Valuation Factors

The value of a business interest is generally based on two things:

- What the company owns, which is reflected on the balance sheet, and
- What the company earns, which is reflected in the income statement.

In valuing a business for tax purposes, the IRS is guided by the factors listed in Revenue Ruling 59-60:[1]

The Nature and History of the Business

Consideration is given to factors such as:

- Size and consistency of the growth rate.
- Stability of the business or lack thereof.
- Products, services and company assets.
- Record of sales.
- Management - especially recent changes.
- Diversity of operations.

Economic Outlook

The general economic outlook and condition of the particular industry in which the business operates will affect how a business is valued. Common questions to be considered include the following:

- Is it a growth industry?
- How competitive is this company in the industry?
- What would be the economic effect of the loss of a key employee?

[1] See Revenue Ruling 59-60, 1959-1 CB 237. Also see Rev. Rules. 65-192, 1965-2 CB 259; 65-193, 1965-2 C. B. 370 and 77-287, 1977-2 CB 319

Business Valuation Factors

The Book Value of the Stock

- Based on assets minus liabilities - to show liquidity position.
- Believed to be unreliable in valuing most businesses.

The Earning Capacity of the Company

This is perhaps the most significant factor:

- Earning capacity is average earnings over a five-year period multiplied by a capitalization rate.
- There is no standard table of capitalization rates.
- Capitalization rates are usually based on price-earnings ratios of similar, publicly traded companies.

The Dividend Paying Capacity

This is considered to be a primary factor:

- This does not mean dividends actually paid, but the capacity to pay.
- The IRS recognizes the need to retain a reasonable portion of the profits for expansion needs.

Goodwill and Other Intangible Values

- Goodwill is based on earning capacity. It represents an excess of net earnings over and above a fair return on the net tangible assets of the business.
- Other intangibles include the following:
  - Ownership of a trade or brand name.
  - Prestige and renown of the business.
  - Prolonged successful operation in a particular locality.

Prior Sales and Size of Block

- Prior sales may be meaningful if they were arms-length transactions.
- Small isolated sales or distress sales are not significant.
- Valuation of a controlling interest may carry a premium value.
- Valuation of a minority interest should include a discount.

Similar Companies

How the business performs in comparison to its competitors is another consideration. For example, the valuation may consider the market price of stocks of similar, publicly traded corporations.

- Companies must be sufficiently comparable.
- The comparative appraisal method examines price-earnings, price-book value, and price-dividend ratios of each corporation.

Weight to Be Given to Each Factor

Some factors will carry more weight than others. There is no exact mathematical formula.

A study by Standard Research Consultants[1] showed that in 74 tax cases the most frequently used factors were:

- Sale price, in 33 cases;
- Book value, in 24 cases; and
- Earning power, in 17 cases.

Earnings will typically have more importance in companies selling products and services, whereas net worth will be more important in real estate holding companies.

[1] Study by Standard Research Consultants, as quoted in the CLU Journal, Vol. 34, No. 2, April 1980, pp. 61-70.