INHERITANCE TAX. Closely held stock and Good Will - when carried as an asset, value cannot be determined by par value of stock or book value, but must be determined on basis of net earnings.

Oral

November 1, 1934.

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Hon. Richard R. Nacy,
State Treasurer,
Jefferson City, Missouri.

Attention: Mr. E. Arnett

Dear Sir:

This department is in receipt of your request for an opinion as to the valuation of closely held stock for the purpose of inheritance taxation in the State of Missouri.

The valuation of this type of security is a very difficult and complex problem for the reason that the securities, because they are closely owned, had no market price and we are therefore faced with the necessity of establishing a fair market value of a security never offered for sale on the market.

The valuation of this type of security becomes more difficult because of the many intangible items entering into the consideration, such as Good Will; i.e., in considering Good Will we must add to the value of the stock an amount over and above the amount shown by the tangible assets of the corporation. "Commerce Clearing House, Inc., Inheritance Tax Service."

The United States Board of Tax Appeals had this question before it in the case of Appeal of the Surviving Executors of the Estate of Jacob Fish, Dec., 1 B.T.A. 882. In that case the Board said:

> "****The stock of the corporation here in question was closely held, and we therefore are not able to value it upon the basis of sales in an open market. We place our valuation upon the basis of the assets underlying the capital stock and the earnings of the corporation."

The actual mechanics of the valuation are clearly set out by the Board in the latter part of its opinion. It was said:

> Passing to the more material evidence in the appeal, it appears from the balance sheets submitted that the net worth of the corporation on December 31, 1921, preceding the death of the decedent, after

adjustment on account of the value of real estate, was $2,742,850.05, being $137.14 per share. It further appears that the total net earnings for 71 months, to and including December, 1922, were $1,565,247.70, after deduction of taxes, or at the rate of $264,587.66 per year. It further appears that there were included in the assets of the corporation as of December 31, 1921, real estate of the value of $510,000 and securities of the value of $414,508.04. If a 5 per cent return were allowed upon these assets, amounting to $46,225.40, and the average earnings per year based upon the 71 months above mentioned, less the above return upon real estate and securities, or $218,362.26 were capitalized at 15 per cent, the value of the going business, real estate, and securities would be as follows:

1. The average net earnings.....$264,587.66
2. Five per cent return on real estate and securities.....46,225.40
3. The balance to be capitalized at 15 per cent...........218,362.26
4. The above figure capitalized at 15 per cent..........1,455,748.40
5. The value of real estate and securities to be added to the capitalized value of the business..................924,508.04
6. The total value of the assets and going business as of Dec. 31, 1921, based upon the earnings for 71 months......2,380,256.44 or a value of $119.01 per share.

* * * * * "

In the case of In Re Felton's Estate, decided by the Supreme Court of California, 169 P. 392, the Court said (l.c. 393):

"Respondent does not question the rule that the market value of stock at the date of the death of the appellant's father is the proper basis for the fixing of the tax, nor that generally such market value is quite distinct from the ratio between the number of shares assessed and the value of the corporation's property.

* * * *

> But the Felton Company is a close family corporation. Its shares of stock have never been upon the market and they have never been sold privately. According to the views of respondent, the only way to establish the market value of such shares of stock is to ascertain the value of the property which they represent, assigning to each share its proportionate worth. This is the method of determining market value which has been adopted in New York and approved by the courts. In re Jones, 172 N.Y. 575, 65 N.E. 570, 60 L.R.A. 476; In re Crawford, 85 Misc. Rep. 283, 147 N.Y. Supp. 235; In re Valentine (Sur.) 147 N.Y. Supp. 231."

The Commerce Clearing House, Inc. in their work "Inheritance Tax Service", in discussing this problem, quotes Article XIII of the Federal Regulations as follows:

> "Thus Article XIII of the Federal Regulations (which reflects the vast administrative experience in this important field) provides: 'Stock in a close corporation should be valued upon the basis of the company's net worth, earning and dividend capacity and all other factors having a bearing upon the value of the stock. Complete financial and other data upon which the estate bases its valuation should be submitted in duplicate with the return.'"

CONCLUSION

In view of the foregoing, it is the opinion of this department that the value of closely held corporate stock and Good Will (being the capitalization of that portion of the earning power of a business which is not credited to other assets) where carried as an asset on the books of a corporation, must be determined largely upon the basis of net earnings of the business for a reasonable period of time, capitalized at reasonable or established rates.

Respectfully submitted,

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Assistant Attorney General

APPROVED:

ROY McKITTRICK,
Attorney General