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Revenue Ruling 77-287
Internal Revenue Service
1977-2 C.B. 319

Section 2031.-Definition of Gross Estate

26 CFR 20.2031-2: Valuation of stocks and bonds.
(Also Sections 170, 2032, 2512; 1.170A-1, 20.2032-1, 25.2512-2.)

Valuation of securities restricted from immediate resale. Guidelines are set forth for the valuation, for Federal tax purposes, of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securi-ties laws; Rev. Rul. 59-60 ampli-fied **.**

Rev. Rul. 77-287

SECTION 1. PURPOSE.

The purpose of this Revenue Rul-ing is to amplify Rev. Rul. 59-60, 1959-1 C.B. 237, as modified by Rev. Rul. 65-193, 1965-2 C.B. 370, and to provide information and guidance to taxpayers, Internal Revenue Service personnel, and others concerned with the valuation, for Federal tax pur-poses, of securities that cannot be im-mediately resold because they are re-stricted from resale pursuant to Fed-eral securities laws. This guidance is applicable only in cases where it is not inconsistent with valuation require-ments of the Internal Revenue Code of 1954 or the regulations thereunder. Further, this ruling does not establish the time at which property shall be valued.

SEC. 2. NATURE OF THE PROBLEM.

It frequently becomes necessary to establish the fair market value of stock that has not been registered for public trading when the issuing company has stock of the same class that is actively traded in one or more securities mar-kets. The problem is to determine the difference in fair market value be-tween the registered shares that are actively traded and the unregistered shares. This problem is often encoun-tered in estate and gift tax cases. How-ever, it is sometimes encountered when unregistered shares are issued in ex-change for assets or the stock of an ac-quired company.

SEC. 3. BACKGROUND AND DEFINITIONS.

.01 The Service outlined and re-viewed in general the approach, meth-ods, and factors to be considered in valuing shares of closely held corpo-rate stock for estate and gift tax pur-poses in Rev. Rul. 59-60, as modified by Rev. Rul. 65-193. The provisions of Rev. Rul. 59-60, as modified, were extended to the valuation of corporate securities for income and other tax purposes by Rev. Rul. 68-609, 1968-2 C.B. 327.

.02 There are several terms cur-rently in use in the securities industry that denote restrictions imposed on the resale and transfer of certain se-curities. The term frequently used to describe these securities is "restricted securities," but they are sometimes re-ferred to as "unregistered securities," "investment letter stock," "control stock," or "private placement stock." Frequently these terms are used inter-changeably. They all indicate that these particular securities cannot law-fully be distributed to the general pub-lic until a registration statement relat-ing to the corporation underlying the securities has been filed, and has also become effective under the rules pro-mulgated and enforced by the United States Securities & Exchange Commis-sion (SEC) pursuant to the Federal securities laws. The following repre-sents a more refined definition of each of the following terms along with two other terms-"exempted securities" and "exempted transactions."

(a) The term "restricted securities" is defined in Rule 144 adopted by the SEC as "securities acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering."

(b) The term "unregistered securi-ties" refers to those securities with re-spect to which a registration state-ment, providing full disclosure by the issuing corporation, has not been filed with the SEC pursuant to the Securi-ties Act of 1933. The registration state-ment is a condition precedent to a public distribution of securities in in-terstate commerce and is aimed at pro-viding the prospective investor with a factual basis for sound judgment in making investment decisions.

(c) The terms "investment letter stock" and "letter stock" denote shares of stock that have been issued by a corporation without the benefit of fil-ing a registration statement with the SEC. Such stock is subject to resale and transfer restrictions set forth in a letter agreement requested by the issuer and signed by the buyer of the stock when the stock is delivered. Such stock may be found in the hands of either individual investors or institu-tional investors.

(d) The term "control stock" indi-cates that the shares of stock have been held or are being held by an offi-cer, director, or other person close to the management of the corporation. These persons are subject to certain requirements pursuant to SEC rules upon resale of shares they own in such corporations.

(e) The term "private placement stock" indicates that the stock has been placed with an institution or other in-vestor who will presumably hold it for a long period and ultimately arrange to have the stock registered if it is to be offered to the general public. Such stock may or may not be subject to a letter agreement. Private placements of stock are exempted from the registration and prospectus provisions of the Securities Act of 1933.

(f) The term "exempted securities" refers to those classes of securities that are expressly excluded from the regis-tration provisions of the Securities Act of 1933 and the distribution provisions of the Securities Exchange Act of 1934.

(g) The term "exempted transac-tions" refers to certain sales or distri-butions of securities that do not involve a public offering and are ex-cluded from the registration and pro-spectus provisions of the Securities Act of 1933 and distribution provisions of the Securities Exchange Act of 1934. The exempted status makes it unnec-essary for issuers of securities to go through the registration process.

SEC. 4. SECURITIES INDUSTRY PRAC-TICE IN VALUING RESTRICTED SECURITIES.

.01 *Investment Company Valua-tion Practices.* The Investment Com-pany Act of 1940 requires open-end investment companies to publish the valuation of their portfolio securities daily. Some of these companies have portfolios containing restricted securi-ties, but also have unrestricted securi-ties of the same class traded on a se-curities exchange. In recent years the number of restricted securities in such portfolios has increased. The following methods have been used by investment companies in the valuation of such re-stricted securities

(a) Current market price of the un-**restricted stock** less a constant percent-age discount based on purchase dis-count;

(b) Current market price of unre-stricted stock less a constant percent-age discount different from purchase discount;

(c) Current market price of the un-**restricted stock** less a discount amor-tized over a fixed period;

(d) Current market price of the unrestricted stock; and

(e) Cost of the **restricted stock** until it is registered.

The SEC ruled in its Investment Company Act Release No. 5847, dated October 21, 1969, that there can be no automatic formula by which an invest-ment company can value the restricted securities in its portfolios. Rather, the SEC has determined that it is the re-sponsibility of the board of directors of the particular investment company to determine the "fair value" of each issue of restricted securities in good faith.

.02 *Institutional Investors Study.* Pursuant to Congressional direction, the SEC undertook an analysis of the purchases, sales, and holding of securi-ties by financial institutions, in order to determine the effect of institutional activity upon the securities market. The study report was published in eight volumes in March 1971. The fifth volume provides an analysis of restricted securities and deals with such items as the characteristics of the restricted securities purchasers and issuers, the size of transactions (dollars and shares), the marketability dis-counts on different trading markets, and the resale provisions. This re-search project provides some guidance for measuring the discount in that it contains information, based on the ac-tual experience of the marketplace, showing that, during the period sur-veyed (January 1, 1966, through June 30, 1969), the amount of discount allowed for restricted securities from the trading price of the unrestricted securities was generally related to the following four factors.

(a) *Earnings.* Earnings and sales consistently have a significant influ-ence on the size of restricted securities discounts according to the study. Earn-ings played the major part in estab-lishing the ultimate discounts at which these stocks were sold from the current market price. Apparently earnings pat-terns, rather than sales patterns, deter-mine the degree of risk of an invest-ment.

(b) *Sales.* The dollar amount of sales of issuers' securities also has a major influence on the amount of discount at which restricted securities sell from the current market price. The re-sults of the study generally indicate that the companies with the lowest dollar amount of sales during the test period accounted for most of the trans-actions involving the highest discount rates, while they accounted for only a small portion of all transactions in-volving the lowest discount rates.

(c) *Trading Market.* The market in which publicly held securities are traded also reflects variances in the amount of discount that is applied to restricted securities purchases. Accord-ing to the study, discount rates were greatest on restricted stocks with unre-stricted counterparts traded over-the-counter, followed by those with unre-stricted counterparts listed on the American Stock Exchange, while the discount rates for those stocks with un-restricted counterparts listed on the New York Stock Exchange were the smallest.

(d) *Resale Agreement Provisions.* Resale agreement provisions often affect the size of the discount. The dis-count from the market price provides the main incentive for a potential buyer to acquire restricted securities. In judging the opportunity cost of freezing funds, the purchaser is analyz-ing two separate factors. The first fac-tor is the risk that underlying value of the stock will change in a way that, absent the restrictive provisions, would have prompted a decision to sell. The second factor is the risk that the con-templated means of legally disposing of the stock may not materialize. From the seller's point of view, a discount is justified where the seller is relieved of the expenses of registration and public distribution, as well as of the risk that the market will adversely change be-fore the offering is completed. The ultimate agreement between buyer and seller is a reflection of these and other considerations. Relative bargaining strengths of the parties to the agree-ment are major considerations that in-fluence the resale terms and conse-quently the size of discounts in restricted securities transactions. Certain provisions are often found in agree-ments between buyers and sellers that affect the size of discounts at which restricted stocks are sold. Several such provisions follow, all of which, other than number (3), would tend to re-duce the size of the discount:

(1) A provision giving the buyer an option to "piggyback", that is, to regis-ter **restricted stock** with the next regis-tration statement, if any, filed by the issuer with the SEC;

(2) A provision giving the buyer an option to require registration at the seller's expense;

(3) A provision giving the buyer an option to require registration, but only at the buyer's own expense;

(4) A provision giving the buyer a right to receive continuous disclosure of information about the issuer from the seller;

(5) A provision giving the buyer a right to select one or more directors of the issuer;

(6) A provision giving the buyer an option to purchase additional shares of the issuer's stock; and

(7) A provision giving the buyer the right to have a greater voice in op-erations of the issuer, if the issuer does not meet previously agreed upon oper-ating standards.

Institutional buyers can and often do obtain many of these rights and options from the sellers of restricted securities, and naturally, the more rights the buyer can acquire, the lower the buyer's risk is going to be, thereby reducing the buyer's discount as well. Smaller buyers may not be able to negotiate the large discounts or the rights and options that volume buyers are able to negotiate.

.03 *Summary.* A variety of meth-ods have been used by the securities industry to value restricted securities. The SEC rejects all automatic or me-chanical solutions to the valuation of restricted securities, and prefers, in the case of the valuation of investment company portfolio stocks, to rely upon good faith valuations by the board of directors of each company. The study made by the SEC found that restricted securities *generally* are issued at a dis-count from the market value of freely tradable securities.

SEC. 5. FACTS AND CIRCUMSTANCES MATERIAL TO VALUATION OF RE-STRICTED SECURITIES.

.01 Frequently, a company has a class of stock that cannot be traded publicly. The reason such stock cannot be traded may arise from the securi-ties statutes, as in the case of an "in-vestment letter" restriction; it may arise from a corporate charter restric-tion, or perhaps from a trust agree-ment restriction. In such cases, certain documents and facts should be ob-tained for analysis.

.02 The following documents and facts, when used in conjunction with those discussed in Section 4 of Rev. Rul. 59-60, will be useful in the valua-tion of restricted securities:

(a) A copy of any declaration of trust, trust agreement, and any other agreements relating to the shares of **restricted stock**;

(b) A copy of any document show-ing any offers to buy or sell or indica-tions of interest in buying or selling the restricted shares;

(c) The latest prospectus of the company;

(d) Annual reports of the company for 3 to 5 years preceding the valua-tion date;

(e) The trading prices and trading volume of the related class of traded securities 1 month preceding the val-uation date, if they are traded on a stock exchange (if traded over-the-counter, prices may be obtained from the National Quotations Bureau, the National Association of Securities Dealers Automated Quotations (NASDAQ), or sometimes from broker-dealers making markets in the shares);

(f) The relationship of the parties to the agreements concerning the re-stricted stock, such as whether they are members of the immediate family or perhaps whether they are officers or directors of the company; and

(g) Whether the interest being val-ued represents a majority or minority ownership.

SEC. 6. WEIGHING FACTS AND CIR-CUMSTANCES MATERIAL TO RE-STRICTED STOCK VALUATION.

All relevant facts and circumstances that bear upon the worth of **restricted stock**, including those set forth above in the preceding Sections 4 and 5, and those set forth in Section 4 of Rev. Rul. 59-60, must be taken into ac-count in arriving at the fair market value of such securities. Depending on the circumstances of each case, certain factors may carry more weight than others. To illustrate:

.01 Earnings, net assets, and net sales must be given primary considera-tion in arriving at an appropriate dis-count for restricted securities from the freely traded shares. These are the elements of value that are always used by investors in making investment de-cisions. In some cases, one element may be more important than in other cases. In the case of manufacturing, producing, or distributing companies, primary weight must be accorded earnings and net sales; but in the case of investment or holding companies, primary weight must be given to the net assets of the company underlying the stock. In the former type of com-panies, value is more closely linked to past, present, and future earnings while in the latter type of companies, value is more closely linked to the ex-isting net assets of the company. See the discussion in Section 5 of Rev. Rul. 59-60.

.02 Resale provisions found in the restriction agreements must be scruti-nized and weighed to determine the amount of discount to apply to the preliminary fair market value of the company. The two elements of time and expense bear upon this discount; the longer the buyer of the shares must wait to liquidate the shares, the greater the discount. Moreover, if the provisions make it necessary for the buyer to bear the expense of registration, the greater the discount. However, if the provisions of the **restricted stock** agree-ment make it possible for the buyer to "piggyback" shares at the next offer-ing, the discount would be smaller.

.03 The relative negotiation strengths of the buyer and seller of re-stricted stock may have a profound effect on the amount of discount. For example, a tight money situation may cause the buyer to have the greater balance of negotiation strength in a transaction. However, in some cases the relative strengths may tend to can-cel each other out.

.04 The market experience of freely tradable securities of the same class as the restricted securities is also significant in determining the amount of discount. Whether the shares are privately held or publicly traded affects the worth of the shares to the holder. Securities traded on a public market generally are worth more to investors than those that are not traded on a public market. Moreover, the type of public market in which the unrestricted securities are traded is to be given consideration.

SEC. 7. EFFECT ON OTHER DOCU-MENTS.

Rev. Rul. 59-60, as modified by Rev. Rul. 65-193, is amplified.