# CHAPTER 1

# Standards of Business Valuation







## SUMMARY

To determine the value of a business, one must first define the meaning of *value*. Although there are various definitions of value, the exclusive definition for federal tax purposes is found in the term *fair market value*. For other purposes, other standards of value include fair value, investment value, intrinsic value, and transaction value.

*Fair market value* is defined by the U.S. Department of the Treasury (the "Treasury") and involves a consideration of all relevant factors to determine value. It assumes an arms-length transaction between a willing buyer and willing seller, who are not under any compulsion to buy or sell. The buyers and sellers are hypothetical, as is the market in which the transaction takes place. Although individual characteristics of the actual transaction may occasionally be considered, they usually are not.

The buyer and seller are presumed to have knowledge of reasonable, relevant facts relating to the hypothetical transaction as of a specific valuation date.

*Fair value* is the standard of value used in shareholder and (since the first edition of this book) some divorce suits, as well as financial accounting. In both the financial accounting and shareholder suit contexts, it is analogous to, but distinct from, fair market value and is defined by state statute, by the Financial Accounting Standards Board (FASB) and Generally Accepted Accounting Principles (GAAP). Fair value, as used by the accounting profession for the preparation of financial statements, differs in at least two significant aspects from fair market value, as discussed below.

*Investment value* is a subjective concept, used to determine value from the perspective of the individual investor and takes into account individual characteristics of the investor. *Intrinsic value* is the value of securities or a business from the perspective of a security analyst. *Transaction value* is the standard used to determine the value of merchandise imported into the United States. (Transaction value used in this context differs from transaction value in the context of transfers of controlling interests in companies.)

## INTRODUCTION



Like beauty, value is in the eye of the beholder. What has value to one person may be inconsequential to another. Unlike beauty, however, the economic value of a business interest involves more than mere subjective perception, and takes into account a multitude of factors ranging from financial matters to historical perspectives.

Business interests are valued in a variety of contexts and for a variety of reasons. Different instances in the life of a business provide opportunities for governments to tax businesses and their owners. For example, if a business pays dividends to its owners in kind, a tax is imposed and the value of the dividend must be ascertained in order to report and calculate that tax. When businesses are sold, the government asserts a tax and the business must be valued. If a person transfers a business interest by bequest or gift, it must be valued for estate and gift tax purposes.

In the private sector, banks must know the value of businesses when lending money or foreclosing on properties, and buyers and sellers of business interests must agree on a value to proceed with a sale.

To value a business interest, we must have a standard of value or a definition of value that is relevant, predictable, and reliable. The same business interest may have different values if more than one standard is used. Value depends on which definition applies, and in what context the interest is being valued. We will use the terms *standard of value* and *definition of value* interchangeably.

Consider the various definitions of value throughout the life cycle of a diamond. In one sense, the diamond is nothing more than carbon, an inert mineral found in the earth's layers. In this regard, except for its limited commercial use, the diamond has little inherent value. If we define the diamond's value based on its raw mineral content, we have an object of fairly low value. We cannot eat it, drive it to work, or use it to take shelter when it rains; the diamond has a value equal to the sum of its carbon content.

Change the definition of value. Instead of measuring the diamond's value strictly by the economic value of carbon, we instead define the diamond's value by a standard that measures carats, clarity, cut, and color. We also value the diamond as a perceived commodity, advertised to the public as an object of beauty with special cultural and economic value. Except for the enhancement created by cutting and polishing, the diamond is still just inert carbon; if we continue to value the diamond by its pure mineral status, it has limited economic value. When we value the diamond by a standard that puts a premium on beauty and permanence, however, we increase its value considerably. The emphasis of value has changed, and so has the value to the average consumer.

Now let us suppose that our diamond is purchased from a retail store for $1,000 and given to a young woman as an engagement gift. The diamond has a transaction value equal to its purchase price, but, in the hands of the woman, the diamond now has a new value measured by her sentiment; she would likely refuse an offer from someone to buy her diamond, even if the amount offered were significantly more than its original purchase price.

Assume further that the diamond is insured, and, regrettably, is stolen. The insurance policy provides that the diamond is insured for its actual cash value. Alternatively, some insurance policies may replace the diamond at today's cost. Either way, the diamond's value is then determined by the terms of a contract.

Finally, suppose that the diamond ends up in an estate that must be valued for federal estate tax purposes. Fair market value is now the standard of value, as determined by Treasury regulations.

As this example illustrates, there are a variety of different standards of value that can be used, ranging from intrinsic value to contractual value. Similarly to the diamond valuation, business valuation is also subject to varying standards of valuation. Our first task is thus to define the appropriate standard or definition of value.

Among the various standards used to define business value are fair market value, fair value, intrinsic value, and investment value. It is possible, indeed likely, that the same business interest could have different values, depending on which standard of value we use. For federal tax purposes the standard is fair market value. We therefore examine the nuances of fair market value in this chapter.



## SOURCES FOR DEFINING VALUE

### Statutes

One should always consult statutes in the relevant subject area to determine the applicable standard. If a business valuation issue arises in the context of a state law controversy, one should look to the state statutes for the relevant definition of value. State law defines fair value for purposes of corporate mergers, dissenting shareholders' rights, and, in some states since the first edition of this book, family law and divorce issues.

In federal law, the Employee Retirement Income Security Act of 1974, the Securities Act of 1933, and the Internal Revenue Code (the "Code"), all address valuation issues. If a valuation issue involves federal taxes, however, federal tax law provides the controlling standard. There are many sections of the Code that refer to fair market value, yet no section specifically defines it. As we shall see, the definition used for federal tax purposes comes from the Treasury Regulations (the "Regulations" or "Regs").[1]

### Treasury Regulations

As noted, the Code does not define the term *fair market value*, but the Regulations do. It is common for Congress to enact a statute and then delegate to the Treasury Department the responsibility of providing the detailed rules necessary to interpret the Code and carry out congressional intent. Like statutes, Treasury Regulations have the full force of law.

Treasury Regulation section 20.2031-1(b) defines fair market value as:

> *the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.*

This definition is critical to all issues involving federal tax valuation, and we will discuss it more fully later in this chapter.



### Case Law

In addition to statutes and regulations, case law influences definitions of value by applying statutory definitions to the facts of individual cases. Cases thus offer perspectives that affect the definition of value.

Accordingly, one should always consult the relevant case law to understand how the courts have applied a given definition of value to a particular set of facts. Unfortunately, there are some shortcomings in the use of case law as a means to define and elaborate on business value. Five specific concerns are considered here:

1. *Fact-specific cases.* Valuation cases tend to be factually voluminous and very specific to those facts. Although there might be similarities in the factual patterns, there are always differences. Lawyers are taught at an early stage in law school how to minimize the importance of these factual differences when they want to use a case as favorable precedent, and to highlight the importance of these differences when they want to discourage the use of a case as precedent. Valuation case law is almost always instructive, but is not necessarily precedential, in part because of the specific nature of the facts of each case.
2. *Inconsistencies and confusion.* The reader of valuation case law can become easily confused when trying to discern clear valuation principles from different cases. This is at least in part due to inconsistencies among the cases. For instance, one case may layer several separate discounts to arrive at a value, while another clearly combines them into one discount; one case may weigh various factors to arrive at fair market value while another avoids a weighted approach. Which is right, and why are they inconsistent?

   We rely on case law as an essential element of our jurisprudence. Our common law inheritance tells us that fairness and justice require treating people the

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[1] Also, there are thousands of sections of the Regulations that refer to *fair market value*.

same when their legal circumstances are the same. Theoretically then, two valuation cases should reach the same result if the facts and circumstances are the same. It does not always work out that way in practice for several reasons:

- The facts of each case are unique.
- Lawyers present their cases based on their own strategies and theories, which will vary from case to case, and from lawyer to lawyer.
- Witnesses may or may not be credible. If a witness lacks sincerity or consistency, the evidence he or she testifies to may be less credible.
- The introduction and admissibility of evidence often varies from one case to another. In different cases, the same evidence may not be offered, or may not be admitted over an objection. The trier of fact may only decide a case based upon the evidence in the trial record.
- Experts often disagree with one another about the proper valuation methods. The trier of fact may choose to accept or reject expert testimony in whole or in part. Sometimes, experts testify differently in different cases. Inconsistent expert testimony often produces inconsistent results in the case law.
- The trier of fact, whether a judge or a jury, will vary in terms of sophistication, experience, perception, and judgment when it comes to valuation decisions.

For all of these reasons, it is not surprising that valuation cases can seem inconsistent, even if the facts appear similar.

3. *Terminology.* One must be careful when reading cases for valuation guidance to make sure that, even where a particular standard is used, the standard has been correctly defined and implemented. For instance, some cases state that they are using fair market value. We know that fair market value has a specific meaning and definition under the Regulations, but we must ensure that the proper components are present and make up an integral part of the valuation analysis. Unfortunately, not all cases uniformly and consistently apply valuation standards, even where the term *fair market value* may be used.
4. *Differences among circuits.* Federal tax cases are first tried in one of the federal trial courts: either a federal district court, the U.S. Tax Court, the Court of Federal Claims, or a Bankruptcy Court. After trial, cases may be appealed to an appellate level court. Cases in the district courts are appealable to the various circuit courts that govern their geographic areas. Tax Court cases are appealable to the circuit where the taxpayer resides. Cases from the Claims Court are appealable to the Federal Circuit, while Bankruptcy cases are appealable primarily to the district courts. Sometimes the circuit courts will arrive at conflicting results, and, when they do, the conflict may be resolved by one last appeal to the U.S. Supreme Court. Unless the Supreme Court decides to weigh in on a split between circuits, different precedent may be set in different circuits. We will look at this in Chapter 2, when we examine how different circuits analyze subsequent events to determine value.
5. *Federal versus state.* Federal case law interpreting the Treasury definition of fair market value is directly relevant in determining value for federal tax purposes. On the other hand, state courts' interpretations of state definitions of value may not be helpful in a federal tax case. A sophisticated reader of case law must appreciate all these nuances to fully understand the impact of case law on valuation.

## Contracts and Agreements

Another source for the definition of value is a contractual agreement. Parties to a contract are free to negotiate their own definition of value to meet their special situation. We note, however, that the Internal Revenue Service (the "Service") is not bound by the parties' determination of business value, especially if the parties are not bargaining at arm's length. Values (and the definitions of value) agreed to by family members are often suspect to the Service and to the courts.

The following are examples of contractual definitions of value:

- Parties to buy-sell agreements often determine value by specific terms and conditions, which may or may not conform to any generally accepted legal definition of value. Some of these contracts may provide that the value of a business is defined by its book value, or by a multiple of earnings. Other contracts may indicate that the value is defined by the business's earnings before interest, taxes, depreciation, and amortization. Contractual measures of value are limited only by the creativity of the parties.
- Insurance contracts provide for specific values as a basis for coverage. The insurance contract may limit coverage to the actual cash value of an insured item, less its accumulated depreciation. If so, that contract provides the definition of value. Business interruption insurance agreements provide specific definitions of what value they will cover if a business is interrupted for various reasons.
- A corporation's articles of incorporation, its bylaws, or its board resolutions may contain business valuation terms. Such terms are common for buy-out or buy-in clauses, which define the value to the shareholders, as well as the conditions of the sale.
- Lawyers commonly prepare pre-incorporation agreements to address issues such as the value of property that will be part of the opening balance sheet of a corporation.
- A prenuptial agreement is a contract where the intent of the parties is clearly to assign value to, and control the division of, marital assets.
- Lawyers negotiate the value and nature of certain structured settlements to resolve complex litigation.



## Revenue Rulings and Other Treasury Pronouncements[2]

The Treasury will issue Revenue Rulings (abbreviated as "Rev. Rul.") and Revenue Procedures ("Rev. Proc."), which are announced positions of the Service. Some of these rulings are directly related to establishing business value. For instance, Rev. Rul. 59-60 provides detailed methodology relating to the valuation of closely held corporate stock and other business interests. It lists eight factors to consider, as a minimum, when determining the value of closely held business interests. Rev. Rul. 93-12 relates to minority discounts in the context of family-owned businesses.

Unlike statutes and regulations, Revenue Rulings and other Treasury pronouncements do not carry the force of law. Nevertheless, these are important

[2] See Chapter 24.

standards that directly relate to valuation, and one is well advised to consult the published rulings of the government for guidance on valuation issues.

### Professional Associations

Professional associations frequently define standards of value. One such association is the Financial Accounting Standards Board (FASB), which is primarily responsible for establishing financial reporting standards in the United States. The FASB's standards are known as Generally Accepted Accounting Principles (GAAP). GAAP uses predominantly transaction-based valuation—that is, a value established in an actual exchange or transaction by the reporting entity. Accountants view values established in arm's-length exchanges as less subjective and more easily verified than values produced without an exchange.

A number of FASB releases pertain to the fair value of various assets, rather than their fair market value. For instance, Statement of Financial Accounting Standards (SFAS) No. 133 requires certain financial instruments to be reported on the balance sheet at fair value, with gains and losses included in current earnings. SFAS No. 157 prescribes the specific methods for arriving at fair value. These standards, while not law, certainly have an important influence on how assets are valued and reported for financial statement purposes. (Fair value in this context is quite different from fair value in the context of state statutes governing dissenting shareholder rights and partnership/corporate dissolution rights.)



## DEFINITIONS OF VALUE

With all of these potential sources for standards of value, it is essential that all persons engaged in trying to determine value understand and agree, at the outset, on the proper definition of value.

### Fair Market Value

We emphasize the Code's fair market value over the other standards of value because fair market value permeates all of the valuations done for federal tax matters. It is estimated that there are several hundred sections in the Code that involve fair market value in one manner or another. As noted earlier, the Regulations define fair market value as:

> *the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.*[3]

**History of Fair Market Value** We trace the first use of the term *fair market value* to *United States v. Fourteen Packages of Pins*.[4] In that case, the issue was whether the manufacturer shipped pins from England to the United States with a ''false

[3] Treas. Reg. § 20.2031-1(b).

[4] *United States v. Fourteen Packages of Pins*, 25 F.Cas. 1182, 1185 (D.C.Pa. 1832).

valuation'' on the invoice; if it did, the shipment was illegal. In deciding that issue, the court ruled that fair market value, market value, current value, true value, and actual value all require the same inquiry: namely, what is the true value of the item in question?

Although the court in that case effectively held that *fair market value* was synonymous with other like terms, today we know that the term *fair market value* has been given a precise meaning separate and apart from other valuation terms.

The term *fair market value* appears to have been used in the revenue law as early as the 1918 Revenue Act. Section 202(b) of the Act stated that for purposes of determining gain or loss on the exchange of property, the value of any property received shall be the cash equivalent of its *fair market value*. The law offered no further explanation of the term *fair market value*, and the committee reports underlying the Act were equally unhelpful, utilizing the term without explaining it.

In 1919, the Advisory Tax Board (ATB) recommended an interpretation of the term.[5] The ATB stated that the term *fair market value* refers to a fair and reasonable price that both a buyer and a seller—who are acting freely and not under compulsion, and who are reasonably knowledgeable about all material facts—would agree to in a market of potential buyers.

Subsequently, in 1925, the Board of Tax Appeals (the predecessor to the modern-day tax court) stated that the buyer is considered to be a ''willing'' buyer and that the seller is considered to be a ''willing'' seller. The Board also stated that fair market value must be determined without regard to any event that occurs after the date of valuation.[6]

Two years later, the Board of Tax Appeals adopted the ATB's recommendation that fair market value be determined by viewing buyers and sellers who are ''willing, but not compelled'' to buy or sell the item subject to valuation.[7] The Board observed in another case that neither the willing buyer nor the willing seller is an actual person; instead, they are hypothetical persons mindful of all relevant facts. Specifically, the fair market value of an item is determined from a hypothetical transaction between a ''hypothetical willing seller and buyer, who are by judicial decree always dickering for price in the light of all of the facts [and] can not be credited with knowing what the future will yield.''[8]

Finally, in 1936, the U.S. Supreme Court mandated that for federal income tax purposes, fair market value must account for the highest and best use, rather than the actual use of an item. The Court held that two adjacent pieces of land had the same value per square foot, regardless of the fact that one was being used in its highest and best use while the other was not being used at all.[9]



[5] T.B.R. 57, C.B. 1, 40 (April–December 1919).

[6] *Appeal of Charles P. Hewes*, 2 B.T.A. 1279, 1282 (1925).

[7] *Hudson River Woolen Mills v. Comm'r*, 9 B.T.A. 862, 870 (1927).

[8] *National Water Main Cleaning Co. v. Comm'r*, 16 B.T.A. 223, 239 (1929).

[9] *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 60 (1936). Congress has also recognized the notion of ''highest and best use'' as a requirement of fair market value. H.R. Rep. No. 94-1380, at 5 (1976).

**Determining Fair Market Value Today** Today, in order to determine fair market value, the trier of fact must weigh all relevant evidence and draw appropriate inferences.[10] An arm's-length sale of property close to a valuation date is indicative of its fair market value. If an actual arm's-length sale is not available, a hypothetical sale is analyzed. Fair market value represents the price that a hypothetical willing buyer would pay a hypothetical willing seller, both persons having reasonable knowledge of all relevant facts, and neither compelled to buy or sell.[11]

The views of both hypothetical persons must be taken into account, though these may differ from the personal characteristics of the actual seller or buyer.[12] One should not focus too heavily on either the hypothetical seller or buyer, to the exclusion of the other.[13]

Over the years, federal courts have developed a firmly established meaning for the term *fair market value* by enunciating seven standards that must be considered:

1. The buyer and the seller are both willing to engage in the transaction.
2. Neither the willing buyer nor the willing seller is under a compulsion to buy or sell the item in question.
3. The willing buyer and the willing seller are both hypothetical persons.
4. The hypothetical willing buyer and the hypothetical willing seller are both aware of all facts and circumstances involving the item in question.
5. The item is valued at its highest and best use, regardless of its current use.
6. The item is valued without regard to events occurring after the valuation date, unless the event was reasonably foreseeable at the valuation date or was relevant to the valuation.[14]
7. The transaction is for cash and will be consummated within a reasonable commercial time frame.

These standards have evolved over many decades.

When estimating the fair market value of a business interest, one must give meaning to each of the words found in the Treasury's definition:

> *. . . the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.*[15]

[10] Rev. Rul. 59-60, 1959-1 C.B. 237.

[11] *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Snyder v. Comm'r*, 93 T.C. 529, 539 (1989); *Estate of Hall v. Comm'r*, 92 T.C. 312 (1989); See also *Gillespie v. United States*, 23 F.3d 36 (2d Cir. 1994); *Collins v. Comm'r*, 3 F.3d 625, 633 (2d Cir. 1993), *aff'g.* T.C. Memo. 1992-478; Reg. § 20.2031-1(b).

[12] See *Estate of Bright v. United States*, 658 F.2d 999, 1005-1006 (5th Cir. 1981); *Kolom v. Comm'r*, 71 T.C. 235 (1978); *Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990).

[13] See, e.g., *Estate of Scanlan v. Comm'r*, T.C. Memo. 1996-331, 72 T.C.M. (CCH) 160 (1996), *aff'd. without published opinion*, 116 F.3d 1476 (5th Cir. 1997); *Estate of Cloutier v. Comm'r*, T.C. Memo. 1996-49, 71 T.C.M. (CCH) 2001 (1996).

[14] For a full discussion, see Chapter 2.

[15] Treas. Reg. § 1.170A-1(c)(2).

We parse the definition as follows:

1. *Property*. Any business valuation must identify with particularity the precise property that is the subject of the valuation. In most cases, this is easy to do. If we are valuing some shares of MEL Corporation, we can often value the entire corporation and then assign value based on the number of shares at issue. It is a misconception, however, to believe that we must always value a company this way; sometimes, it is possible to value minority interests by themselves, or by reference to other minority interests, without valuing the entire corporation.

   The valuation becomes more difficult if the item is a partial interest in a royalty, patent, or other intellectual property, but it is still comprehensible. The important thing to stress is that what is being valued is some property interest. On occasion, the valuation expert may need a legal opinion to ascertain the identity and nature of the property being valued. The precise definition of the word *property* has legal connotations and significance, particularly where the property is intangible. Business appraisers who are not also lawyers may have difficulty if they carelessly assume the definition of the property being valued.
2. *Would change hands*. The definition of value assumes that a hypothetical transaction will occur, whether a gift, sale, or exchange. The hypothetical transaction is assumed to be happening in a hypothetical market; identifying the hypothetical market and analyzing it is part of the valuer's task. There need not be an actual market for an item to have a fair market value.
3. *Between a willing buyer and a willing seller*. The willing buyer and the willing seller are not the real persons involved in the actual transaction. Rather, the willing buyer and seller are hypothetical persons. These hypothetical buyers and sellers are characteristic of a universe of somewhat sophisticated persons. Imagine such hypothetical persons living in a hypothetical world doing business in a hypothetical market. This market

   > *presupposes enough competition between buyers and sellers to prevent the exigencies of an individual from being exploited. It may well imply that the goods have several possible buyers, so that a necessitous seller shall not be confined to one; and that there are several possible sellers of the same goods or their substantial equivalent, so that a hard-pressed buyer shall not have to accept the first offer.*[16]

   In this universe, there are routine and frequent trades and exchanges of property. It is not important to the definition of fair market value that in the real world there may not be such trades or that they may not be frequent. Instead, the hypothetical buyer and seller are among a multitude of buyers and sellers who in the aggregate constitute a hypothetical market based on hypothetically frequent arm's-length transactions for the subject property.

   Occasionally, a court may permit the item's subjective value to the taxpayer to enter into the definition of fair market value,[17] but almost all the cases recognize that objective, hypothetical evidence of value should dictate the valuation.

[16] *Helvering v. Walbridge*, 70 F.2d 683, 684 (2d Cir. 1934), *cert. denied*, 293 U.S. 594 (1934).
[17] *Turner v. Comm'r*, T.C.Memo. 1954-38, 13 T.C.M. (CCH) 462, 465 (1954).

Thus, the taxpayer's opinion that her diamond has great sentimental value must be disregarded if that sentiment is not a view that is held by the universe of hypothetical buyers and sellers.

We realize, however, that real transactions take place with real persons in real markets. When real considerations exist, and those real considerations are essential to the valuation,[18] those realities must be taken into consideration.[19] The goal, therefore, is to perform the valuation in the context of the real market, with real persons, without individualizing the hypothetical willing seller and willing buyer to such an extent that they lose their hypothetical characteristics. Obviously, there must be some individualizing of the willing buyer and willing seller, or the valuation will lose relevance. For instance, the valuation of a urological medical practice must involve narrowing the consideration of buyers and sellers to physicians.

If this sounds complicated, it is. As a result of this hypothetical model, there is an inevitable tension in trying to describe the hypothetical willing buyer and willing seller without identifying and describing a real buyer and real seller.

In summary, the willing buyer and willing seller are hypothetical persons, but on occasion the individual or subjective characteristics of the buyer and seller must be considered in order to make the valuation more accurate.

4. *Neither being under any compulsion to buy or sell.* The hypothetical willing buyer and seller are not compelled to buy or sell. Thus, a forced liquidation is not within the definition of fair market value. Examples of forced transactions that do not meet the definition of fair market value are bankruptcies, sales compelled by creditors, and sales of property subject to an unexercised option.

   The primary reason forced sales should not be determinative of fair market value is that forced sales distort the price the seller would otherwise receive. A buyer will pay less if the seller is in a hurry to unload the property. One could, of course, argue that all sales are probative of market value, and that disregarding forced sales may taint the true market, which includes sales compelled by financial necessity.

5. *Both having reasonable knowledge of relevant facts.* The hypothetical buyer and seller are not just well informed, but also have reasonably full knowledge of all relevant facts.

   The requirement of full knowledge imposes a burden on the hypothetical buyer and seller to investigate the circumstances relating to the property, the market, and all relevant facts that are reasonably known or could be discovered. In some cases, the hypothetical seller or buyer may be better informed than the actual buyer or seller, because the individual characteristics of the actual buyer and seller are not to be taken into account.[20]



[18] *True v. United States*, 547 F.Supp. 201, 204 (D. Wyo. 1982).

[19] *Estate of Winkler v. Comm'r*, T.C. Memo. 1989-231, 57 T.C.M. (CCH) 373 (1989).

[20] *Estate of Trenchard v. Comm'r*, T.C. Memo. 1995-121, 69 T.C.M. (CCH) 2164, 2169 (1995), stating that "(t)he willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer."

Suppose that a person owns stock in a closely held corporation. Based on the assertions of the corporation's chief financial officer and a two-year-old appraisal of the business performed by a reputable, independent business valuer, the owner believes the corporation is worth $30 per share. On that basis, she makes gifts of the stock and files gift tax returns. Assume that the Service audits the taxpayer and concludes that the gifts are worth $50 per share. Resolution of this controversy will involve, in part, whether the actual taxpayer's "investigation" of the stock's value measures up to the kind of thorough investigation the hypothetical buyer or seller would have performed.

Would a hypothetical taxpayer be satisfied with a two-year-old appraisal? Would a hypothetical taxpayer rely on the assertions of the chief financial officer without examining comparable stocks? The answers to these questions turn on all of the facts and circumstances of the transaction. Regardless of what the actual taxpayer did or failed to do, the hypothetical buyer or seller is presumed to have conducted an investigation to discover all relevant facts. If the actual seller or buyer did not conduct such an investigation, the Service may successfully challenge her valuation.

Finally, while the hypothetical buyer and seller have reasonable knowledge of all relevant facts, they are not presumed to be omniscient of all obscure or minuscule information. As with many areas of the law, reasonableness permeates valuation controversies and grants some relief for the honestly mistaken taxpayer.



**Valuation Approaches** Generally, three approaches are used to determine the fair market value of a business or business interest: the market approach, the income approach, and the asset-based approach.

The market approach values a business interest based on the market price of comparable interests. The income approach computes the present value of the estimated future cash flows of the business. The asset-based approach examines a company's assets and liabilities to assess a value. The three approaches are the subjects of Chapters 15, 16, and 17.

## Fair Value

The term *fair value* is used in many state statutes as well as in GAAP. In state law, fair value is the standard often applicable to dissenting stockholders' appraisal rights and, since the first edition of this book, in some states for marital dissolution cases. With respect to GAAP, *fair value* is employed by accountants to prepare financial statements.

**State Law** For instances where a shareholder has a right to an appraisal, such as in a merger or share exchange, different states use different definitions of fair value. However, twenty-three states have adopted the terms of the Revised Model Business Corporation Act of 1984, which defines fair value as:

> *the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.*

Ten states have adopted a newer definition from the 2005 Model Business Corporation Act (MBCA), which looks to evolving economic concepts and valuation methodologies to establish fair value, stating,

> *''fair value'' means the value of the corporation's shares determined:*
>
> *(i) immediately before the effectuation of the corporate action to which the shareholder objects;*
> *(ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and*
> *(iii) without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles . . .*

The comments to the MBCA note that the corporation and its shares are valued ''as they exist immediately before the effectuation of the corporate action requiring appraisal,'' stating also that,

> *(m)odern valuation methods will normally result in a range of values, not a particular value. When a transaction falls within that range, 'fair value' has been established. Absent unusual circumstances, it is expected that the consideration in an arm's-length transaction will fall within the range of 'fair value' . . . a court determining fair value should give great deference to the aggregate consideration accepted or approved by a disinterested board of directors for an appraisal-triggering transaction.*

While the definitions of fair value differ among states, most do not equate fair value with fair market value, and accordingly, business valuations that are performed for state controversies adopt a different standard than that which is used for federal tax valuations and controversies.

**Fair Value and GAAP** As previously noted, accountants use fair value as their standard in the preparation of financial statements. Financial statements prepared by Certified Public Accountants must conform to GAAP, and are used not only by the clients for whom they are prepared but also by lending banks, buyers of businesses, the Securities and Exchange Commission, and countless others.

While fair value has been the standard for the accounting industry, it was not until 2006 that a comprehensive definition of fair value was published. The Financial Standards Accounting Board issued SFAS No. 157 for the purpose of ''increased consistency and comparability in fair value measurements and for expanded disclosures about fair value measurements.'' This standard, effective November 15, 2007, defines fair value as,

> *the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

The new standard includes a hierarchy of components to consider when measuring fair value, and divides them into three levels of inputs:

1. Quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
2. Inputs other than quoted prices for the asset or liability, either direct or indirect.
3. Unobservable inputs for the asset or liability, which reflect the reporting entity's assessment of market participant assumptions for pricing the asset or liability. This level "is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date."[21]

**Comparison of GAAP Fair Value to Fair Market Value** Sometimes, practitioners use *fair value* and *fair market value* interchangeably. Since the GAAP definition of fair value is so important, it is worthwhile to examine its underlying premises. While the components of fair market value were discussed above, the fair value accounting standard incorporates the following key principles:[22]

- Fair value is based on an exchange price, from the perspective of the seller (the exit price), in a hypothetical transaction at the measurement date.
- The exchange price is the price in an orderly transaction which allows for due diligence, and is not from a distressed sale or a forced transaction.
- Fair value measurement assumes that the asset is sold in its principal market or, in the absence of a principal market, the most advantageous market.
- Fair value is determined based on the assumptions that market participants would use in pricing the asset or liability. A fair value measurement would include an adjustment for risk if market participants would include one, as well as the effect of restrictions on the sale or use of an asset.
- Company-specific information should be factored into fair value measurement when relevant information is not observable in the market.
- Companies measuring the fair value of their own liabilities should include the effect of their credit risk.

**Recent Developments in Fair Value** Both fair market value and fair value standards require that assets be referenced to a market. Under either standard, when the market becomes exceptionally volatile or irrational, assets may be especially hard to value.

When a drastic downturn in the market occurs, asset values based on the market can correspondingly decrease. In 2008, such mark-to-market accounting was thought to have contributed to the collapse of hundreds of financial institutions, when billions of dollars in complex financial instruments were revalued at the collapsed market's value.

To complicate the issue further, some assets' values are derivative of other assets' values, whether blocks of mortgages or insurance contracts. When the

[21] Statement of Financial Accounting Standards No. 157, Fair Value Measurements, Summary p. 157-3. Statement of Financial Accounting Standards No. 157, Fair Value Measurements, Summary, pp. 157–53.
[22] Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting; Office of the Chief Accountant, Division of Corporate Finance, United States Securities and Exchange Commission, pp. 22–23.

market for the underlying assets disintegrates, how are the derivative assets to be valued? Moreover, when there is no ready market to reference, what is the difference in asset value when comparing fair value and fair market value?

The Tax Court addressed the differences in fair value and fair market value in *Bank One Corporation v. Commissioner*,[23] where the taxpayer argued that GAAP fair value met the requirements of fair market value for purposes of valuing derivatives under Code section 475.[24] On appeal, the Seventh Circuit affirmed the Tax Court's holding that the standards were not the same.[25] Subsequent regulations now provide a safe harbor, which permits certain dealers in securities and commodities to use GAAP fair value standards for financial reporting and fair market value for tax reporting purposes.[26]

FASB Guidance has been issued for valuing assets when the market becomes inactive, and new standards interject more judgment on the part of the valuers.[27] Using the hierarchy outlined above, when no suitable market exists, a business may be able to rely on its own financial models and assumptions to determine its asset values.[28] While businesses may now incorporate fair value accounting standards for tax valuations, the interdependence of the values of so many assets in the markets have revealed severe vulnerabilities inherent in our current financial system.

**SFAS 141R "Business Combinations"** On December 7, 2007, the FASB issued a revised version of SFAS No. 141, namely SFAS No. 141R. Both statements deal with the presentation of a domestic acquirer's financial statements, both before and after a business combination transaction. Under SFAS No. 141R, the consideration for an acquisition will be measured and recognized at fair value at the acquisition date. The underlying principle of SFAS No. 141R is to recognize all assets acquired and liabilities assumed at fair value at the acquisition date (with some exceptions such as deferred income taxes, employee benefits, and share-based payments that will continue to be measured according to other GAAP rules).

SFAS 141 eliminated the pooling method of accounting for business combinations and replaced it with the purchase method that involves a purchase price allocation of the price to the assets purchased. The most significant change in the purchase price allocation procedure was the new criteria established in SFAS No. 141 to recognize intangible assets apart from goodwill. There were five categories of intangible assets defined in SFAS No. 141:

1. marketing-related intangible assets
2. customer-related intangible assets

[23] Bank One Corporation v. Comm'r, 120 T.C. 174 (2003), aff'd in part, vacated in part, JPMorgan Chase & Co. v. Comm'r, 458 F.3d 364 (7th Cir. 2006).
[24] I.R.C. § 475 requires similar mark-to-market accounting for tax purposes; certain securities, including derivatives, are to be valued as if sold at fair market value on the last business day of the tax year.
[25] JPMorgan Chase & Co., 458 F.3d at 569.
[26] Treas. Reg. § 1.475(a)-4.
[27] FASB Staff Position, FAS 157-3, issued October 10, 2008.
[28] Id., See also FAS 157.

3. artistic-related intangible assets
4. contract-based intangible assets
5. technology-based intangible assets

While in SFAS 141, the pooling method was eliminated and replaced by the purchase method, in SFAS No. 141R, the purchase method was renamed the "acquisition method," in an effort to show more clearly what types of transactions result in a business combination.

Some of the important changes under SFAS No. 141R include the following:

- Transaction costs are expensed in the period incurred under SFAS No. 141R. (Under SFAS No. 14, they were included in the purchase price and capitalized.)
- Contingent consideration is recorded at fair value at the acquisition date and measured again at the end of each reporting period. (Under SFAS No. 141, contingent consideration was not recognized and was recorded as goodwill, if and when paid.)
- In-process R&D is recorded at fair value, has an indefinite life, and is subject to future impairment testing until completed or abandoned under SFAS No. 141R. (Under SFAS No. 141, in-process R&D was expensed at the acquisition date.)
- If an acquiring company obtains control but less than 100 percent of the target company, then any residual goodwill is allocated between the controlling interests and the noncontrolling interests. (Previously, the residual goodwill was only allocated to the controlling interest.)

**SFAS 141R and Accounting Standards Codification ASC 805** In July 2009, the Financial Accounting Standards Board launched the Accounting Standards Codification (the FASB ASC). The FASB ASC replaced all previously existing financial accounting standards (except for U.S. Securities and Exchange Commission pronouncements) to become the single source of authoritative nongovernmental U.S. GAAP. Going forward, instead of issuing new standards (e.g., SFAS 142), the FASB will issue updates to the FASB ASC, and financial statements will no longer refer to specific accounting standards.

As a result, the FAS 141R "Business Combinations" is now referred to as ASC Section 805, and FAS 157 "Fair Value Measurements" is now ASC Section 820.

### Investment Value

We have observed that fair market value necessarily involves hypothetical buyers, hypothetical sellers, and a hypothetical marketplace. The term *investment value* differs significantly from fair market value, and focuses on the value to a *particular* buyer, seller, owner, or investor. Unlike fair market value's hypothetical buyer and seller, we take into consideration a multitude of individualized factors when considering investment value, including:

- The economic needs and abilities of the parties to the transaction
- The parties' risk aversion or tolerance
- Motivation of the parties
- Business strategies and business plans

- Synergies and relationships
- Strengths and weaknesses of the target business
- Form of organization of the target business

### Intrinsic Value

*Intrinsic value* is a concept of value commonly used by analysts evaluating publicly held securities. Unlike investment value, which considers the circumstances of a particular investor or owner, intrinsic value considers value from the perspective of the analyst. For example, if a stock is trading on the New York Stock Exchange at $30 per share, and a security analyst says, "I believe it is worth $40 per share based on my fundamental analysis," the $30 is fair market value, and the $40 is that analyst's estimate of intrinsic value.

### Transaction Value

*Transaction value* is a standard of value used for customs valuation. Goods imported into the United States may be subject to various tariffs, and must be appraised based on their transaction value. While tariffs are a form of taxation, the Internal Revenue Service does not have authority to review the value of merchandise as it is imported. Rather, the administrative agency responsible for confirming valuations is Customs and Border Patrol, a division of the Department of Homeland Security. Customs valuation will be discussed more fully in Chapter 10.[29]



## PREMISE OF VALUE

In a fair market value analysis, one must make an underlying assumption regarding the facts and circumstances of the subject or transaction being valued. The various assumptions which influence the valuation may be summarized as follows:

1. *Value as a going concern.* Value in continued use, as a mass assemblage of income-producing assets, and as a continuing business enterprise.
2. *Value as an assemblage of assets.* Value in place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise.
3. *Value as an orderly disposition.* Value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of an orderly disposition. This premise contemplates that all the assets of the business enterprise will be sold individually, and that they will enjoy normal exposure to their appropriate secondary market.

[29] "Transaction value" is also the term some people apply to the proceeds received in the sale of a property. For example, some companies may pay more than stand-alone fair market value for an acquisition because of perceived synergies. See Fishman et al., *Guide to Business Valuations*, 20th ed. (Fort Worth, TX: Practitioners Publishing Co., 2010).

4. *Value as a forced liquidation.* Value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually and that they will experience less than normal exposure to their appropriate secondary market.[30]

## CONCLUSION

While different standards of valuation are used for different purposes, the correct standard of valuation for federal tax purposes is fair market value. The definition of fair market value is found in Treasury materials and has been refined over the years by the many courts that have dealt with the issue (see Chapter 24). Proper valuation for federal tax purposes requires an intricate knowledge of this complex concept.



[30] Shannon P. Pratt, *Valuing a Business*, 5th ed. (New York: McGraw-Hill, 2008): 48.