Chapter 1

Standards of Business Valuation

SUMMARY

To determine the value of a business, one first must 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 nonfederal tax purposes, other standards for business value include fair value, investment value, and intrinsic 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 seller performing a transaction, without 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 defined by state statutes and separately by the Financial Accounting Standards Board (FASB) for financial accounting purposes. Fair value is analogous to, but distinct from, fair market value. For state law purposes, fair value is used to determine value for dissenting or oppressed shareholders and occasionally in marital dissolution.

Another use of fair value is found in generally accepted accounting principles (GAAP)

used by the accounting profession in the preparation of financial statements. There are at least two significant differences between fair value as used for GAAP and fair market value.

Investment value is a subjective concept, determining value from the perspective of the individual investor and thus taking into account individual characteristics.

Intrinsic value is the value of securities or a business from the perspective of a security analyst.

INTRODUCTION

Like beauty, value is in the eye of the beholder. What is value to one may be inconsequential to another. In this regard, value is mere subjective perception. Unlike beauty, however, the economic value of a business interest involves more than mere subjective perception. Valuation of a business interest involves 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 purposes. Governments use events and circumstances relating to business as opportunities to tax businesses and their owners. For instance, when businesses are sold, pay dividends in kind, or are the subject of a taxable estate, the government asserts a tax and the business interest must be valued. Lending institutions value businesses when money is lent, or when properties are foreclosed. Estates and gifts of property also must be valued to determine whether such interests are taxed.

To value a business interest, we must have a standard or definition of value. We use *standard of value* synonymously with *definition of value*. Stated concisely, business value must be measured and defined by a definition of value that is relevant, predictable, and reliable. Recognizing that the same business interest may have different values if more than one standard of value is used, value becomes largely a matter of definition.

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, the diamond, except for some limited commercial uses, 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, a fiction due in large part to the millions of dollars poured into advertisements convincing the public that the diamond has special economic value as an object of beauty. Except for some limited 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 takes on 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 determined by the terms of a contract.

Finally, suppose that the diamond ends up in an estate that must value it for federal estate-tax purposes. Fair market value is now the standard, 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, business valuation is also subject to varying standards of valuation. Our first task is thus to define the appropriate standard 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 emphasize fair market value, and its nuances, in this chapter.

SOURCES FOR DEFINING VALUE

Statutes

One should always consult statutes in the specific subject area that is being valued, as federal or state statutes often define the relevant standard of value. For instance, the Employee Retirement Income Security Act (ERISA) and the federal securities laws address valuation issues. There are many sections in the Internal Revenue Code ("the Code") that refer to fair market value.[1] Given the frequent usage of *fair market value* in the Code, it is somewhat surprising that none of these sections actually defines the term. As we shall see, the definition of fair market value is left to the Treasury Regulations ("the Regs" or "the Regulations").

States also have statutes that define value in the context of mergers, dissenters' rights, marital dissolutions, and family issues. If the business value issue arises in the context of a state law controversy or nonfederal valuation, one should heed the definition of value found in the state's statute. However, if the valuation involves federal taxes, state law does not control the definition of value and one should follow the Code and Treasury Regulations.

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 the responsibility of providing the detailed rules necessary to carry out congressional intent. Like statutes, Treasury Regulations have the full force of law.

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

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 when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties 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 the regulations interpreting them, definitions of value are influenced by case law that applies 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 court applies 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 of one case compared to another, 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 because of the specific nature of the facts of each case.
2. *Inconsistencies and confusion.* The reader of valuation case law can easily become confused when trying to arrive at clear valuation principles from the case law. This is so, at least in part, due to inconsistencies among the cases. For instance, one case may combine discounts to arrive at a valuation amount, while another clearly separates each discount as a distinct item. One case may weigh factors used in arriving at fair market value while another avoids weighing the same factors. Which is right? Why are they inconsistent?

   We rely on case law as an essential element of our jurisprudence. Our common law inheritance defines fairness and justice as treating people the same when their legal circumstances are the same. Accordingly, two valuation cases should theoretically reach the same result if the circumstances and facts of the two cases are the same. It does not always work out that way in practice for several reasons.

   Case law is the product of many variables:

   - The facts of each case likely will be unique.
   - Lawyers present their cases based on their own strategy and theory of the case. The lawyers' strategies and theories will vary from case to case, as lawyers see things differently.
   - Witnesses may present themselves differently. Some witnesses may be credible, while others lack sincerity. If a witness lacks credibility, the evidence that the witness testifies to may also lack credibility.

- The introduction and admissibility of evidence often varies from one valuation case to another. The trier of fact can decide a case based only on the trial record. If evidence does not get into the record because it was not offered, or was not admitted because of some objection, the record evidence in one trial may be different from that of another trial in which such evidence was admitted.
- Experts often disagree with one another about the proper valuation. The trier of fact may choose to accept or reject expert testimony in whole or in part. Sometimes, experts testify one way and then testify another in a different case. Inconsistent expert testimony often produces inconsistent results among cases.
- The trier of fact, whether it be a judge or 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 with prior cases, even where many of the facts look similar.

3. *Terminology.* One must be careful when reading cases for valuation guidance to make sure that, even though a particular standard of valuation is utilized, the standard has been correctly defined and implemented. For instance, some cases will say that they are using fair market value. We know that fair market value has a specific meaning and definition under the Regulations. Even though a case may state that it is using the fair market value standard, one must ensure that the components of fair market value, as defined by the Regulations, are actually present and an integral part of the valuation analysis. Unfortunately, not all case law reveals a uniform and consistent application of valuation standards, even though the terms used look correct.
4. *Differences among circuits.* Federal valuation cases are first tried by a federal trial court. These courts are the federal district courts, the U.S. Tax Court, the Court of Federal Claims, and the U.S. Bankruptcy Courts. These cases are then appealable to the appellate courts. Cases from the Claims Court are appealed to the Federal Circuit. Cases in the district courts are appealable to the various circuit courts that govern their geographic area. Tax Court cases are appealed to the various circuit courts in which the taxpayer resides. Sometimes, the circuit courts will arrive at conflicting results with one another, and, when they do, the conflict may be resolved by one last appeal to the U.S. Supreme Court. Remember that a precedent in one circuit may not be the same as that in another circuit. For instance, the application of subsequent events in one circuit may not be precisely the same in another.
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 that interpret state definitions of value may not be at all helpful when trying to argue 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 definitions of value may be found in contractual agreements of the parties. Parties to a contract are free to bargain for their own definition of value to meet their special situation. We note, however, that the Internal Revenue Service (also called the Service in this book) 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) arrived at between family members are often suspect to the Service and to the courts.

Examples of contractual definitions of value are the following:

- Parties to buy-sell agreements often determine value by specific terms and conditions in contracts, which may or may not conform to any accepted definition of value in any general legal context. 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 of the business is defined by earnings before interest, taxes, depreciation, and amortization. Contractual measures of value are limited only by the creativity of the parties to the contract.
- Insurance contracts provide for specific values as a basis for their 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 just what values they will cover if a business is interrupted due to various insured causes.
- 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 and define their conditions as well as shareholder value.
- 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 control the division and assign value 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 (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 valuation of closely held business interests. Rev. Rul. 93-12, relates to minority discounts in the context of family-owned businesses.

Revenue Rulings and other Treasury pronouncements, unlike statutes and Regulations, do not carry the force of law. Nevertheless, these are important standards that directly relate to valuation, and one is well advised to consult the published rulings of the government for guidance on valuation issues.

[2]See Chapter 22.

Professional Associations

Professional associations frequently define standards of value. An example is the Financial Accounting Standards Board (FASB), a professional organization 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, valuation 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 fair value of various assets. 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. Whereas SFAS No. 133 does not prescribe specific methods for arriving at fair value, it does describe in general terms possible methods for determining fair value. These standards, while not law, certainly have an important influence on the definition of fair value 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 nonfederal 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.*

History of Fair Market Value

We trace the first use of the term *fair market value* to *United States v. Fourteen Packages of Pins.*[3] In that case, the issue was whether the manufacturer shipped pins from England to the United States with a "false 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

[3]H. Rept. 767, 65th Cong., 2d Sess. (1918), 1939-1 C.B. (Part 2), 86, 88.

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 part of the 1918 Revenue Act. Section 202(b) of that Act stated that for purposes of determining gain or loss on the exchange of property, the value of any property received equals the cash value 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.[4] There, 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 (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.[5]

Two years later, the Board of Tax Appeals adopted the ATB's recommendation that fair market value be determined by viewing neither the willing buyer nor the willing seller as being under a compulsion to buy the item subject to valuation.[6] The Board observed in another case that neither the willing buyer nor the willing seller is an actual person; instead, they are viewed as hypothetical persons who are 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] cannot be credited with knowing what the future will yield."[7]

Finally, in 1936, the U.S. Supreme Court mandated that for federal income tax purposes, fair market value is determined by viewing the item under consideration on the basis of its best use. In the same case, the Supreme Court held that two adjacent pieces of land should be valued at 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.[8]

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

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

[6]*Hudson River Woolen Mills v. Comm'r*, 9 B.T.A. 862, 868 (1927).

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

[8]*St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 60 (1936). The notion of "highest and best use" has also been recognized by Congress as a requirement of fair market value. H. Conf. Rept. 94-1380, at 5, 1976-3 C.B. (Vol. 3) 735.

Determining Fair Market Value Today

Today, determination of fair market value is a inquiry in which the trier of fact must weigh all relevant evidence of value and draw appropriate inferences.[9] An arm's-length sale of property close to a valuation date is indicative of its fair market value. If actual arm's-length sales are not available, 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, with neither person compelled to buy or sell.[10]

The views of both hypothetical persons must be taken into account, and the characteristics of each hypothetical person may differ from the personal characteristics of the actual seller or a particular buyer.[11] Focusing too much on the view of one hypothetical person to the neglect of the view of the other is contrary to a determination of fair market value.[12]

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 in determining fair market value:

1. The buyer and the seller are a willing buyer and a willing seller.
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 in question is valued at its highest and best use, regardless of its current use.
6. The item in question 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.[13]
7. The transaction is for cash and will be consummated within a reasonable commercial time frame.

These standards have evolved over many decades.

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[9]Rev. Rul. 59-60.

[10]*United States v. Cartwright*, 411 U.S. 546 (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).

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

[12]See, e.g., *Estate of Scanlan v. Comm'r*, T.C. Memo. 1996-331, *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).

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

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.*[14]

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 being valued. 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 needing to value 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 it be 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; the item is valued on the basis of what a willing buyer and willing seller would buy and sell for, based on hypothetical sales of the item.
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, which is the subject of the valuation. Rather, the willing buyer and seller are hypothetical persons. These hypothetical buyers and hypothetical 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. The market may be described as follows:

   > *[A] "market" itself 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.*[15]

   In this universe, there are trades and exchanges of property happening on a routine and somewhat frequent basis. 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

[14]Reg. § 1.170A-1(c)(2).
[15]*Helvering v. Walbridge*, 70 F.2d 683,684 (2d Cir. 1934), *cert. denied*, 293 U.S. 594 (1934).

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,[16] but almost all the cases recognize that objective, hypothetical evidence of value should dictate the valuation. 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,[17] those realities must be taken into consideration.[18] The valuation task, 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 character. 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 are considered, where doing so makes the valuation more accurate.

4. *Neither being under any compulsion to buy or sell.* The hypothetical willing buyer and the hypothetical willing seller are assumed to be performing without any compulsion to buy or to sell, other than the normal concerns that buyers and sellers have. 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 why forced sales should not be determinative of fair market value is this: When people sell under a compulsion, they act in haste and do not allow for the normal time it takes to market property so as to achieve its true value. Indeed, common sense suggests that a buyer may get a better deal by buying from a seller who 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 does involve sales compelled by financial necessity.

5. *Both having reasonable knowledge of relevant facts.* This aspect of the definition is critical in that it requires both the hypothetical buyer and seller to be not just well informed, but to also have reasonably full knowledge of all relevant facts. Therefore, a sale of an interest in

[16]See *Turner v. Comm'r*, 13 T.C.M. 463, 465 (1954).

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

[18]*Estate of Winkler v. Comm'r*, 57 T.C. Memo 382 (1989).

> a business by a seller who did not have reasonable knowledge of relevant facts cannot be the basis for a market comparable under the market comparability approach.
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> 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 reasonably are known or could be discovered. In some cases, the hypothetical seller or buyer may be better informed than the actual buyer or seller. Although this might seem illogical, remember that actual buyers or sellers have individual characteristics that are not taken into account when creating the hypothetical buyer and the hypothetical seller.[19]

In another example, suppose that a person owns stock in a closely held corporation. She believes the stock is worth $30 a share based on the assertions of the corporation's chief financial officer and a review of a two-year-old appraisal of the business performed by a reputable, independent business valuer. On that basis, gifts are made and gift tax returns are filed with the Service. Assume that the Service audits the taxpayer and concludes that the gifts are worth $50 a 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 could have performed.

For example, 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 looking for other comparable transactions to verify the accuracy of the valuation? The answers to these questions turn on all of the facts and circumstances of the transaction. The point is that, 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. Failure to be informed of all relevant facts means the valuation does not meet the fair market value standard and can be successfully challenged by the Service.

Finally, even though 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 fair market value: the market approach, the income approach, and the asset-based approach.

The market approach values an item by looking at the market price of a comparable item. The income approach computes the present value of the estimated future cash flows of the item by taking the sum of the present value of the available cash flow and the present value of the residual value, or by capitalizing the indicated future level of maintainable cash flows or earnings. The asset-based approach examines the underlying company assets and liabilities to assess a value for the company.[20]

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[19]*Estate of Trenchard v. Comm'r*, 69 T.C. Memo 2169 (1995) ("The 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.")

[20]See Chapters 14, 15, and 16.

Fair Value

The term *fair value* is used in many state statutes as well as in GAAP. In state statutes, fair value is the valuation definition employed for dissenting stockholders' appraisal rights and sometimes for marital dissolution.

With respect to GAAP, *fair value* is often associated, and used interchangeably, with *fair market value*, and is employed by accountants in the preparation of financial statements.

State Law

The Revised Model Business Corporation Act (RMBCA) 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.*

As previously observed:

> *The statutory definition of fair value in 32 states is similar to the definition provided by the RMBCA. . . . The definition in several other states is similar, but without the "unless exclusion would be inequitable" clause. . . . The definition of fair value in Delaware and Oklahoma is similar to that of the several other states, but includes a clause that states, "In determining such fair value, the court should take into account all relevant factors."*[21]

Most state courts have not equated fair value with fair market value when interpreting their own statutes. Accordingly, business valuations that are performed for state controversies adopt a different standard than that which is used for federal tax valuations and controversies.

As noted, each state generally enacts a statute that defines the term *fair value*. We look at Illinois, for example, which defines *fair value* in a manner designed to resemble but not match *fair market value*, as defined by the Treasury.

With regard to a noncash asset, the Illinois Code specifies that:

> *(a) [fair value is] the amount at which that asset could be bought or sold in a current transaction between arms-length, willing parties;*
> *(b) quoted market price for the asset in active markets should be used if available; and*
> *(c) if quoted market prices are not available, [fair value is] a value determined using the best information available considering values of like assets and other valuation methods.*

In ruling on the question of fair value, the Illinois courts have held that the fair value of an item may be the same as its fair market value, but not always.[22] The Illinois courts have also

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[21]Shannon P. Pratt, *The Lawyer's Business Valuation Handbook* (Chicago: American Bar Association, 2000): 7, quoting from Daniel R. Van Vleet, Chapter 9A: "Fair Value in Dissenting Stockholder Disputes, in *Financial Valuation: Businesses and Business Interests*," U9A-6 (James H. Zukin, ed., 1999). This chapter lists the definitions of fair value in each state.

[22]*Laserage Technology Corp. v. Laserage Laboratories, Inc.*, 972 F.2d 799, 805 (7th Cir. 1992); see also *Institutional Equipment & Interiors, Inc. v. Hughes*, 562 N.E. 2d 662 (Ill. 1990) (holding that the fair market value valuation method did not apply, but fair value did).

noted that the state legislature has given them much flexibility in applying the concept of "fair value."[23] Over time, these courts have created a nonexclusive list of factors that are used in determining the fair value of an asset. These factors include earning capacity, investment value, history and nature of the business, economic outlook, book value, dividend-paying capacity, and market price of stock of similar businesses.[24]

Fair Value and GAAP

As previously noted, accountants use fair value as their standard in the preparation of GAAP financial statements. Financial statements prepared by certified public accountants 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.

In one pronouncement, the FASB has defined fair value for financial accounting purposes in this way:

> *Value determined by bona fide bargain between well-informed buyers and sellers, usually over a period of time; the price for which an [asset] can be bought or sold in an arm's-length transaction between unrelated parties; value in a sale between a willing buyer and a willing seller, other than in a forced or liquidation sale; an estimate of such value in the absence of sales or quotations.*[25]

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 whether GAAP fair value is in fact the same as Treasury's fair market value.

Comparison of GAAP Fair Value to Fair Market Value

The *fair market value* standard requires the buyer and seller to be aware of all facts and circumstances that are relevant to the valuation. The fair value standard does not require any such knowledge, nor is it required of both parties. Fair value anticipates that the willing buyer and willing seller will be "well informed." While the terms *well informed* and *reasonably aware of all relevant facts and circumstances* appear similar, they are not. One can be well informed and still be unaware of all the facts and circumstances relevant to the valuation.

Second, fair market value requires that neither the willing buyer nor the willing seller be under any compulsion to buy or sell the property that is the subject of the valuation. Fair value states that the property should not be the subject of a forced sale or liquidation.

Are the two terms the same? No. A liquidation is not the same as being under a compulsion to buy or sell: One can liquidate voluntarily without being under some internal com-

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[23] *Weigel Broad. Co. v. Smith*, 682 N.E. 2d 745, 749 (Ill. 1996).

[24] Id.; *Stanton v. Republic Bank of S. Chicago*, 581 N.E. 2d 678, 682 (Ill. 1991); *Independence Tube Corp. v. Levine*, 535 N.E. 2d 927, 930 (Ill. 1988) (more extensive list); *Stewart v. Stewart & Co.*, 346 N.E. 2d 475, 481 (Ill. 1976) (referencing Rev. Rul. 59-60).

[25] Statement of Federal Financial Accounting Standards #11: Amendments to Accounting for Property, Plant and Equipment (July 1999). See *Kohler's Dictionary for Accountants*, "Fair Value" (5th ed., 1983).

pulsion. Also, it is possible for one party to be forced into the transaction while the other party is not. Fair market value requires that neither party be under any compulsion.

Thus, GAAP fair value is a broader term than is fair market value for tax purposes. In some respects, fair value encompasses fair market value.

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 in that investment value denotes value to a *particular* buyer, seller, owner, or investor.

Investment value therefore considers and examines value from the perspective of a particular individual, owner, or investor. Unlike the hypothetical buyer and seller, we take into consideration a multitude of individualized factors when considering investment value, including these seven:

1. The respective economic needs and abilities of the parties to the transaction or event
2. Risk aversion or tolerance
3. Motivation of the parties
4. Business strategies and business plans
5. Synergies and relationships
6. Strengths and weaknesses of the target business
7. Form of organization of the target business

Intrinsic Value

Intrinsic value is a concept of value commonly used by an analyst in evaluating publicly held securities. It is distinguished from investment value in that investment value considers the circumstances of a particular investor or owner, while 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.

PREMISE OF VALUE

In a fair market value analysis, one must make an assumption regarding the transactional facts and circumstances applicable to the subject being valued. This assumption will have a significant influence on the valuation itself and therefore should be considered as part of the business valuation. The various assumptions 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.
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.[26]

CONCLUSION

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 22). Proper valuation for federal tax purposes requires an intricate knowledge of this complex concept.

[26]Shannon P. Pratt, et al., *Valuing a Business*, 4th ed. (New York: McGraw-Hill, 2000): 33.