

**AMERICAN SOCIETY OF APPRAISERS
22ND ANNUAL ADVANCED BUSINESS VALUATION CONFERENCE
CHICAGO, ILLINOIS**

OCTOBER 18, 2003

Valuation Issues: A Perspective from a U.S. Tax Court Judge

The Honorable David Laro
Judge
United States Tax Court
Washington, D.C.

Overview

Valuation is a fascinating subject because, like beauty, value is in the perception of the beholder.¹ One writer has suggested that valuation principles are involved in the biblical quote "eye for an eye." As early as 42 B.C., Publilius Syrus said "Everything is worth what its purchaser will pay for it."² Valuation has permeated countless transactions and issues over the centuries.

Modern tax related valuation issues are ubiquitous. It has been estimated that there are 243 sections of the Internal Revenue Code that require fair market value estimates in order to accurately assess tax liability. Consequently, some researchers report that each year the Internal Revenue Service receives approximately 15 million tax returns and schedules on which taxpayers routinely report an event involving a valuation-related issue with a combined estimated fair market value of about \$60 billion. For instance the gift tax return, Form 709, has a special box to be checked if there is an issue of valuation involved in the gift.

¹ At the outset, I must note that my comments are my personal views which may or may not be harmonious with the views of any of my colleagues on the United States Tax Court for whom I do not speak. I must add further that my views are offered to contribute to enlightened thinking on valuation issues. They do not necessarily indicate how I may rule under the facts and circumstances of a future case.

² Bartlett, Familiar Quotations 1105 (12th ed. 1951).

Anyone approaching the subject of valuation should be aware of certain truisms as a frame of reference. They are:

- (1) Each valuation case is unique. Although guidance can be obtained from earlier cases, each case is unique. One case is rarely on point with another, and a significant differentiation of the facts can usually be made.
- (2) In valuation there are no absolutes. There are only general guidelines to which individual judgments must be applied.
- (3) There is no irrefutable "right" answer.³
- (4) Experts will and do differ. The Supreme Court in 1858 stated "Experience has shown that opposite opinions of persons professing to be experts may be obtained to any amount." Winans v. The New York & Erie Railroad Co., 62 U.S. 88, 101 (1858).
- (5) There are available methods which are generally recognized and accepted by the appraisal profession and the courts.

To state the obvious, the starting point for evaluating businesses is to define the standard for valuation in tax cases.

Fair Market Value Standard

Fair market value does not necessarily mean the same as "fair value", "intrinsic value", or even "investment value". One typical distinction between fair value and fair market value is that most courts do not apply a discount for lack of marketability to closely held stock under the fair value standard, but courts almost always apply a discount for lack of marketability in conjunction with closely held minority interests under the fair market value standard.

The definition of fair market value is that which is found in the Treasury Regulations that define the term "fair market value" for Federal estate and gift tax purposes.⁴ Courts generally use the same definition of fair market value for both of these taxes.⁵ For Federal gift tax purposes, fair market value is determined on the day of each gift, and, ordinarily, no consideration is given to any unforeseeable future event that may have affected the value of the subject property.⁶ The

³ Courts strive to arrive at the "right" answer and generally do. However, courts are fallible and have no monopoly on wisdom. Justice Jackson once said "We are not final because we are infallible, but we are infallible only because we are final." Brown v. Allen, 344 U.S. 443, 540 (Jackson, J., concurring in result).

⁴ Sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs.

⁵ Snyder v. Commissioner, 93 T.C. 529, 539 (1989); Perdue v. Commissioner, T.C. Memo. 1991-478. See also Orth v. Commissioner, 813 F.2d 837, 841 (7th Cir. 1987); Anselmo v. Commissioner, 757 F.2d 1208, 1214 (11th Cir. 1985), affg. 80 T.C. 872, 881 (1983).

⁶ Sec. 2512(a), I.R.C.; sec. 25.2512.1, Gift Tax Regs; see also Estate of Newhouse v.

same is true for Federal estate tax purposes, except that the subject property is valued on either the date of the decedent's death or the alternate valuation date under section 2032, whichever is applicable.⁷

Fair market value is defined in the Treasury's regulations 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."⁸ Each element of the Fair Market Value Definition deserves attention.

The failure to focus on the totality of the definition may lead to an inaccurate or incomplete definition. To be sure, an actual arm's-length sale of the subject property is most indicative of the price that a willing buyer would pay a willing seller on the valuation date, assuming, of course, that the date of the sale is close enough to the valuation date to make both sale prices representative of each other.⁹ It is important to emphasize that mere sales of the subject property may not be sufficient to dictate the proper valuation.

To be controlling, such sales must be arm's-length and hopefully close to the valuation date. See Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982). To be arm's-length, one would expect at the minimum that the seller perform some financial review as to the value of his or her stock or be reasonably informed on the date of sale as to the relevant facts surrounding the underlying property.

The hypothetical sale price is determined on the basis of hypothetical parties. In other words, the willing buyer and the willing seller are not the specific individuals or entities that are parties to the sale. Instead, the willing buyer and the willing seller are hypothetical people, the individual characteristics of which are not necessarily the same as the individual characteristics of the actual seller or the actual buyer.¹⁰ In this respect, we must be careful not to focus too much on one of the hypothetical persons, i.e., a hypothetical willing buyer or seller, to the neglect of the other hypothetical person. Ignoring the views of one of the parties is contrary to the well-established test of fair market value. See Estate of Cloutier v. Commissioner, T.C. Memo. 1996-49.

More importantly, the failure to analyze both sides of the hypothetical transaction may be fatal in that a court may disregard expert testimony as irrelevant. The same is true to the extent that an expert does not interview persons who are representative of the parties at hand, or fails to give the interviewees all relevant information about the subject property.¹¹

Commissioner, 94 T.C. 193, 218 (1990).

⁷ Secs. 2031(a) and 2032(a), I.R.C.; sec. 20.2031-1(b), Estate Tax Regs.

⁸ Sec. 20.2031-1(b), Estate Tax Regs.; see also sec. 25.2512-1, Gift Tax Regs.

⁹ Actual arm's-length sales of the interest within a reasonable time of the valuation date are the best criteria of market value. Ward v. Commissioner, 87 T.C. 78, 101 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982).

¹⁰ Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981); Estate of Newhouse v. Commissioner, supra at 218.

¹¹ Estate of Salisbury v. Commissioner, T.C. Memo. 1975-333.

In determining the fair market value of a given piece of property, we must bear in mind that valuation is a question of fact, and that one must consider all relevant information in order to draw the appropriate inferences.¹²

We also must be mindful that the fair market value of property does not always equal the value of the subject property in its current use. To the contrary, fair market value represents the worth of the subject property in its highest and best use on the valuation date. Fair market value, for example, takes into account special uses that are realistically available due to the property's adaptability to a particular business.¹³ It does not matter that the owner actually has not put the property to its highest and best use. The reasonable and objective possible uses for the property control the valuation thereof.¹⁴

Weighing of Factors

Special rules govern the valuation of corporate stock. When stock is listed on an established securities market, the stock's value usually equals its listed market price. When stock is not listed on such a market, the stock's value is usually based on recent arm's-length sales (if any) of the unlisted stock, that have occurred within a reasonable time of the valuation date.¹⁵ In the absence of recent arm's-length sales, the value of unlisted stock is based on the value of listed stock of the subject corporation, or, if that corporation has no listed stock, the listed stock of like corporations engaged in the same or a similar line of business.¹⁶ Like corporations are determined by reference to the subject corporation's age; business; product line; and gross receipts. Unlisted stock must also be valued by reference to the subject corporation's net worth, its prospective earning power, its dividend-earning capacity, its goodwill, its management, its position in the industry, the economic outlook for its industry, the degree of control represented by the block of its stock to be valued, and the amount and type of its nonoperating assets, if not considered elsewhere.¹⁷

Rev. Rul. 59-60, 1959-1 C.B. 237¹⁸ should be consulted for any business valuation as it

¹² Skripak v. Commissioner, 84 T.C. 285, 320 (1985); Estate of Newhouse v. Commissioner, supra at 217; see also Rev. Rul. 59-60, 1959-1 C.B. 237.

¹³ Stanley Works v. Commissioner, 87 T.C. 389, 400 (1986); see also Mitchell v. United States, 267 U.S. 341, 344-345 (1925).

¹⁴ United States v. Meadow Brook Club, 259 F.2d 41, 45 (2d Cir. 1958); Stanley Works v. Commissioner, supra at 400.

¹⁵ Estate of Andrews v. Commissioner, supra at 940; Duncan Indus., Inc. v. Commissioner, 73 T.C. 266, 276 (1979).

¹⁶ Sec. 2031(b), I.R.C.; Estate of Hall v. Commissioner, 92 T.C. 312, 336 (1989).

¹⁷ See Estate of Hall v. Commissioner, supra at 336; Estate of Andrews v. Commissioner, supra at 940; secs. 20.2031-2(f)(2), Estate Tax Regs.; sec. 25.2512-2(f)(2), Gift Tax Regs.; see also Estate of Lauder v. Commissioner, T.C. Memo. 1994-527.

¹⁸ Rev. Rul. 59-60, 1959-1 C.B. 237, as amplified by Rev. Rul. 77-287, 1977-2 C.B. 319 (valuation of restricted securities); Rev. Rul. 1980-213, 1980-2 C.B. 101 (valuation of stock of certain subsidiary corporations); Rev. Rul. 83-120, 1983-2 C.B. 170 (techniques to value

provides the Internal Revenue Service's general guidelines for valuing closely held corporations. Section 5 of Rev. Rul. 59-60 establishes the comparative weight to be accorded various factors. According to the Service, the following factors, although not inclusive, are fundamental and require careful analysis in each case: (a) The nature and history of the business; (b) the economic outlook; (c) the book value; (d) the earning capacity; (e) the dividend paying capacity; (f) whether the enterprise has goodwill; (g) sales of the stock and the size of the block of the stock to be valued; and (h) the market price of stocks engaged in the same or a similar line of business.¹⁹

Rev. Rul. 59-60 states:

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors * * * and basing the valuation on the result. [Rev. Rul. 59-60, 1959-1 C.B. 237, 243.]

In spite of this, some valuation practitioners apply weights to various factors in reaching their valuation conclusions because this allows them to clearly demonstrate the importance that they attach to various valuation considerations. This approach was used by the Tax Court in Estate of Feldmar v. Commissioner, T.C. Memo. 1988-429;²⁰ Estate of Titus v. Commissioner, T.C. Memo. 1989-466;²¹ Estate of Campbell v. Commissioner, T.C. Memo. 1991-615.²² The weighing of various methods, however, was squarely rejected by the Court in Estate of Mueller v. Commissioner, T.C. Memo. 1992-284.²³

preferred stock versus common stock of closely held corporation); see also Rev. Rul. 65-193, 1965-2 C.B. 370 (valuation of intangible assets).

¹⁹ Rev. Rul. 59-60, 1959-1 C.B. 237 at sec. 4.01.

²⁰ Estate of Feldmar v. Commissioner, T.C. Memo. 1988-429, involved the valuation of stock in a personal holding company. The Court applied an average of three methods: price/earnings ratios of comparable corporations, relationship of market price to book value of comparable corporations, and stock value in previous sales. Weighted values were determined by level of importance to the overall valuation. In determining the company's earnings, the court also gave more weight to years which reflected the company's trend of a decline in earnings.

²¹ Estate of Titus v. Commissioner, T.C. Memo. 1989-466, involved the valuation for estate tax purposes of the closely held stock of a holding company. The Court accepted, with some modifications, the weighing methods applied by both petitioner and respondent, which accorded various weights to adjusted book value, comparable book value, and earnings.

²² Estate of Campbell v. Commissioner, T.C. Memo. 1991-615, involved the valuation for estate tax purposes of a farming and livestock business. Recognizing that the corporation was a combination of a holding and operating company, the Court applied equal weights to both a comparable earnings and net asset approach.

²³ Estate of Mueller v. Commissioner, T.C. Memo. 1992-284, also involved the valuation of a closely held company for estate tax purposes. However, the valuation was complicated by a prospective merger which was being planned around the time of decedent's death. The Court there disapproved an expert's weighing of figures determined to represent a discounted merger value and the value of the minority interest. The Court stated, "We * * * believe that the 'average of averages' is too error-prone." While this case may be distinguishable from the others

With what appears to be conflicting judicial positions on this issue, there is some concern about whether the weighing of factors is a proper method of appraisal.

Because the circumstances of each case are different, it is practically impossible to prescribe a single standard or formula which must be applied in arriving at fair market value. Reasonableness and flexibility are necessary to arrive at an appropriate valuation. Courts must give adequate consideration to a multitude of factors, and the weight accorded each factor likely will be different depending upon the facts, circumstances, and perspective of the case at hand.

One should consider carefully all relevant factors but should not assign weights to each factor. However, practitioners may emphasize a few factors that could influence the ultimate valuation. For example, the nature of the industry, the history of the company, the company's earnings, and any restrictions that apply, are all important aspects, but one of the elements may deserve special emphasis. It is permissible to point out that such factor is critical, influential, or controlling in the appraisal. Courts appreciate relevant, current empirical data which support an appraisal. A report may highlight a critical factor without assigning it a weight as part of a formula.

Lack of Marketability Discount:

When determining the value of unlisted stock by reference to a similar type of listed stock, a discount from the listed value is typically warranted in order to reflect the lack of marketability of the unlisted stock. Such a discount, better known as a "lack of marketability discount" (or, more succinctly, a "marketability discount"), reflects the absence of a recognized market for closely held stock and accounts for the fact that closely held stock generally is not readily transferable. A marketability discount also reflects the fact that a buyer may have to incur a subsequent expense to register the unlisted stock for public sale.²⁴

Minority Discount:

One must be careful not to confuse the marketability discount with the minority discount. A minority discount reflects the fact that a minority shareholder usually cannot control the policy or operations of the underlying corporation. A minority discount also reflects the fact that an investor will usually pay more for a block of stock that represents control, than he or she would pay for a block of stock that is merely a minority interest in the company. The minority discount, therefore, is rooted in a shareholder's lack of control over company policy, whereas the marketability discount is premised on the subject shares' lack of liquidity. Given the distinguishing fact that the marketability discount is not related to control, courts have held that a marketability discount may inhere in the value of an interest in a corporation regardless of the interest holder's percentage of ownership of the corporation's stock.²⁵

in that there were several levels of weighing applied, language in the opinion suggests a general disapproval of the method. The Court observed that by applying slightly different weights, an entirely different figure could have been reached. The Court stated, "These five levels of multiplication also provide five independent opportunities for error."

²⁴ See Estate of Hall v. Commissioner, supra at 341.

²⁵ See Estate of Andrews v. Commissioner, supra at 953.

Combining Marketability and Minority Discounts

In certain cases, it is appropriate to apply both a minority discount and a marketability discount to a particular interest in a corporation. When in doubt and wherever possible, however, separately derived discounts should be applied. In Estate of Andrews v. Commissioner, 79 T.C. 938 (1982), for example, the Court did not distinguish the two discounts. According to the Court, "Because respondent's basis for opposing both discounts is the same--that the hypothetical willing buyer must be seen as a family member--our subsequent discussion, like the parties' briefs, will consider the two discounts together." Estate of Andrews v. Commissioner, supra at 953. In most cases, however, a premium is placed on clear and separate steps in the appraisal report, supported by a compelling application of discrete factors.

Determining the value of unlisted stock, therefore, requires a two-step analysis in the absence of actual sales. First, the value of the unlisted stock must be estimated by reference to the freely traded values of similar types of listed stock. These freely traded values will almost always account for any minority interest discount that is applicable. Second, the estimated value must be discounted to reflect the fact that the unlisted stock is not easily marketable.²⁶ Ascertaining the appropriate discount is a factual determination. Critical to this determination is an appreciation of the elements of value used by an investor in making his or her investment decision.

The various issues involved in valuation and discounts are illuminated by explaining the facts and circumstances of a recent case.

Members of the Mandelbaum family owned all of the shares of Big M, a privately held corporation.²⁷ Big M was founded in 1976 and through adroit management has prospered throughout the years. Big M operates predominantly through two retail divisions of women's apparel stores. At the end of 1990, there were 122 retail stores. The shareholders of Big M executed an agreement in 1982 which provided, among other things, that the board of directors must be a member of the Mandelbaum family. The first agreement did not provide for a price or formula for determining the fair market value of transferred shares of Big M stock. In 1988, a second agreement revoked the first agreement and provided, among other things, that Big M's shareholders fill any vacancies on the board with members of the Mandelbaum family. In addition the agreement provided that any shareholder may freely transfer Big M stock to members of his or her family group but to the extent that the shareholder wanted to transfer Big M stock outside of the group the shareholder must first offer the stock to members of his or her family group on the same terms and conditions on which the stock is offered to others. The members of the shareholder's family group then had 90 days to exercise a right of first refusal.

The case arose because various members of the Mandelbaum family made gifts at certain times and those gifts of Big M stock were challenged by the Internal Revenue Service. In the course of the proceedings at the United States Tax Court, the parties stipulated the fair market

²⁶ See, e.g., Estate of Lauder v. Commissioner, T.C. Memo. 1994-527.

²⁷ Mandelbaum v. Commissioner, T.C. Memo. 1995-255, affd. 91 F.3d 124 (3rd Cir. 1996).

values of the shares of Big M stock but their stipulated values did not include a discount for lack of marketability. Experts for both the Government and petitioners testified with respect to the determination of the value of the marketability discount. The Court, however, did not find complete refuge in the opinions of either expert and accordingly analyzed the various factors which the Court felt pertinent in order to determine the value of the marketability discount.

To determine a marketability discount for unlisted stock, the Court discussed the following factors in its analysis:

- (1) Private versus public sales of the stock,
- (2) An analysis of the financial statements of the company,
- (3) The company's dividend policy,
- (4) The nature of the company, its history, its position in the industry, and its economic outlook,
- (5) The company's management,
- (6) The amount of control in transferred shares,
- (7) Restrictions on transferability of stock,
- (8) Holding period for stock,
- (9) The company's redemption policy, and
- (10) Costs associated with making a public offering.

Since Mandelbaum was released approximately 90 scholarly articles have discussed it and the Internal Revenue Manual on Valuation has highlighted this case.

Market Absorption Discount:

This discount is generally the same as blockage but is applicable to real estate. In the Estate of Aufer v. Commissioner, 75 T.C.M. 2321 (1998), the Court applied a five-part analysis: (1) categorize the assets by type; (2) determine the market value; (3) compare the number of the assets in each category to the number of assets of at type that are traded in the market; (4) determine how much longer than a reasonable time it would take to sell the assets at market value; and (5) discount the assets that can't be sold within that reasonable time. Note however, that the court in this case denied the applicability of this discount to entity owned assets.

Rights of First Refusal:

A common example of a transferability restriction is a right of first refusal. A right of first refusal with respect to corporate stock may result in a marketability discount to the freely traded value of that stock. Usually, however, such a discount is appropriate only when the right references a price or formula (such as book value per share) at which the shares must be first offered to the right's holder. In most cases, especially where an operating company is concerned, a right of first refusal without a fixed price has little, if any, effect on fair market value (which inherently includes the discount, if any, for lack of marketability),²⁸ and such an absence of a

²⁸ See, e.g., Couzens v. Commissioner, 11 B.T.A. 1040, 1164 (1928).

fixed price clearly has a less dramatic effect than fixed-price restrictions.²⁹ Indeed, a right of first refusal without a fixed price does not automatically limit the buyers to whom a seller could sell his or her stock, or a price for that stock, but merely governs the order in which prospective purchasers can buy the stock.³⁰ Given the fact that the right actually protects and benefits the other shareholders who may purchase the shares when a fellow shareholder offers to sell, the depressant effect (if any) on the value of privately held stock subject to a right of first refusal generally tends to be superficial.

Typically, as courts have repeatedly found, rights of first refusal and other transferability restrictions are sometimes merely devices designed by counsel to deflate the value of the subject stock for Federal estate tax or gift tax purposes. Although courts have long recognized that transfer restrictions may legitimately limit the value of stock for these purposes, courts are wary of restrictions that were created merely to deflate the perceived value of stock. Therefore, courts closely scrutinize intra family agreements restricting the transfer of stock in a closely held corporation to determine whether the restriction is bona fide and was reached at arm's length.³¹ In order to be a bona fide agreement, the terms of the restriction should have been reached by all affected parties at arm's length.

Subsequent Events

Courts generally do not use subsequent events to determine the fair market value. The reason for not using subsequent events is that a hypothetical willing buyer and a willing seller should have the same knowledge of all relevant facts at the valuation date; otherwise the very

²⁹ See e.g., Worcester County Trust Co. v. Commissioner, 134 F.2d 578, 581-582 (1st Cir. 1943), revg. Estate of Smith v. Commissioner, 46 B.T.A. 337 (1942); Estate of Reynolds v. Commissioner, 55 T.C. 172, 188-190 (1970).

³⁰ Couzens v. Commissioner, supra at 1163-1164.

³¹ Dorn v. United States, 828 F.2d 177, 182 (3d Cir. 1987); Harwood v. Commissioner, 82 T.C. 239, 259 (1984); Estate of Kelley v. Commissioner, 63 T.C. 321, 325 (1974); Hoffman v. Commissioner, 2 T.C. 1160, 1178-1179 (1943), affd. sub. nom. Giannini v. Commissioner, 148 F.2d 285 (9th Cir. 1945).

equilibrium of the fair market value concept would be ruined.³²

Notwithstanding the Supreme Court's mandate in Ithaca,³³ the courts sometimes do use subsequent events, albeit inconsistently.³⁴ Subsequent events are used by the courts when: (1) the subsequent events were reasonably foreseeable as of the valuation date; or (2) the subsequent events are relevant to the valuation and appropriate adjustments are made to account for the differences between the valuation date and the date of such subsequent events; or (3) the subsequent events are not used to arrive at the valuation but to confirm the valuation already concluded; or (4) subsequent events may be considered if the property being valued is comparable to the property being valued in the subsequent valuation.

Conclusion:

Judges prefer "real world" solutions to valuation issues. Although the definition of fair market value inherently involves a hypothetical buyer and seller, it is likely that judges will require the hypothetical buyer and seller to use terms and conditions which most closely relate to actual business standards utilized contemporaneously on the valuation date. Valuation experts will need to strive to convince the courts that their methods of valuation most accurately reflect market activity. Valuation principles may change over time to accurately reflect contemporaneous business standards. Therefore, there is some danger in relying upon past precedents as a means to provide standards for future decisions. Valuation is a vital and constantly changing process, and the experts who perform valuations will be sufficiently challenged to make sure that their standards are accurate and persuasive.

³² For an excellent demonstration of this point see First National Bank of Kenosha v. United States, 763 F.2d 891, 893-894 (7th Cir. 1985). There, the Court gave the following example:

“Suppose that sometime after decedents’ had died, her executor had discovered oil on the farm--oil that no one had suspected existed. The existence of oil on the land would increase the value of the property tremendously, but it cannot be supposed that a willing buyer on the date of decedent’s death would have considered the presence of oil in calculating how much to offer for the property. The discovery of oil is the kind of ‘subsequent event’ that the rule * * * makes inadmissible, for it is beyond the contemplation of the parties on the relevant valuation date.”

³³ In Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929), the Supreme Court mandated that "the estate so far as may be is settled as of the date of the testator's death".

³⁴ In Estate of Smith v. Commissioner, 198 F.3d 515, 522 (5th Cir. 1999), revg. 108 T.C. 412 (1997), the Court of Appeals for the Fifth Circuit acknowledged the inconsistent and “irreconcilable” use of subsequent events and cited several cases where the courts used or declined to use subsequent events in determining the fair market value.