

Volume 14 | Issue 2

1963

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Recommended Citation

Stephen J. Alfred, *General Considerations*, 14 W. Res. L. Rev. 173 (1963)

Available at: <https://scholarlycommons.law.case.edu/caselrev/vol14/iss2/6>

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Fair Market Value Concept

I

GENERAL CONSIDERATIONS

Stephen J. Alfred¹

PERVASIVENESS OF THE CONCEPT OF "FAIR MARKET VALUE"

There is probably no concept which appears more frequently or in a greater variety of circumstances in our tax laws than does the concept of "fair market value." It is the very essence of the federal gift and estate taxes since fair market value² is not only the measure of what is included in the first instance but also of what is deducted or credited in determining the amount subject to these graduated taxes.³ In addition, the fair market value of property for gift and estate tax purposes has a decisive bearing on the income tax consequences when the property is subsequently disposed of.⁴

But what is frequently not realized is how the same concept pervades the income tax aside from its interplay with the gift and estate tax. There are many areas where it determines the amount of gross income⁵ and of

1. This article is based on an outline prepared by Warren E. Hacker for the Fifth Annual Cleveland Regional Tax Institute.
2. Both the terms "fair market value" and "value" are used in the Internal Revenue Code of 1954; in each case, the meaning is the same.
3. Thus, for gift tax purposes, value is the measure of the amount of the gift, both in the current year, INT. REV. CODE OF 1954, § 2512 [hereinafter cited as CODE §], and in prior years (for purposes of computing the tax in the current year), CODE § 2504(c). It affects the \$3,000 annual per donee exclusion, CODE § 2503(b), and the \$30,000 lifetime exemption, CODE § 2521, as well as deductions for charitable gifts, CODE § 2522, and for gifts to one's spouse, CODE § 2523. For estate tax purposes, property is includible in the gross estate at its value either at the date of death, CODE § 2031, or at one year after death unless disposed of in the meantime, CODE § 2032. Value likewise affects the deductions for charitable bequests, CODE § 2055, and for bequests to one's spouse, CODE § 2056, as well as credits against estate tax for gift tax, CODE § 2012, estate tax on prior transfers, CODE § 2013, and foreign death taxes, CODE § 2014. Value also affects the obtaining of an extension of time for payment of the estate tax, where the estate consists of an interest in a closely-held business, CODE § 6166(a).
4. CODE §§ 1014 (basis of property acquired from a decedent), 1015 (basis of property acquired by gift). See also CODE §§ 303(b)(2) (capital gains or ordinary income treatment of distributions in redemption of stock on death), 691(a)(2) (transfer of right to receive items of income in respect of a decedent).
5. *E.g.*, Treas. Reg. § 1.61-2(d) (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126 [hereinafter cited as Reg. §] (compensation paid in forms other than cash); CODE § 1001(b) (amount realized on sale or other disposition of property); CODE § 301(b)(1) (corporate distributions in kind); CODE §§ 356(a)(1), (b), 361(b) (amount realized on "boor" transactions in corporate organizations and reorganizations); CODE §§ 371(a)(2)(B), (b)(2),

deductions.⁶ Often it governs the basis of property upon its later sale or other disposition⁷ as well as the apportionment or allocation of basis among several properties acquired in a single transaction.⁸ Frequently whether a transaction is a reorganization,⁹ or whether a corporation is collapsible,¹⁰ is a personal holding company,¹¹ or has some other special tax status¹² depends upon the fair market value of particular property. Furthermore, the determination of whether a corporation is a "related taxpayer," *e.g.*, in determining whether losses are deductible¹³ or whether amounts realized are ordinary income or capital gain¹⁴ depends upon the fair market value of a corporation's stock owned by the other party.¹⁵ It is thus apparent that this concept permeates the tax laws and is an important element in many taxable transactions.

374(a)(2)(B) (amount realized on "boot" transactions in insolvency reorganizations); CODE § 1031(b) (amount realized on "boot" transactions on exchanges of property of a like kind, insurance policies, stock for stock in the same corporation and United States obligations); CODE § 1081(e) (amount realized on "boot" transactions on exchanges of stock or securities in obedience to S.E.C. orders); CODE §§ 1332(a), 1333(1) (war loss recoveries); CODE § 421 (restricted stock options); Reg. § 1.421-6 (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161 (non-restricted stock options). With regard to the latter, note that the unique term "readily ascertainable" fair market value is employed; see discussion at 223 *infra*.

6. *Helvering v. Owens*, 305 U.S. 468 (1939) (casualty loss of non-business property); *Edison Bros. Stores, Inc.*, 45 B.T.A. 472 (1941), *aff'd.*, 133 F.2d 575 (8th Cir.), *cert. denied*, 319 U.S. 752 (1943) (business expenses satisfied in kind); Reg. § 1.170-1(c) (1958) (charitable contributions in property).

7. *Heiner v. Tindle*, 276 U.S. 582 (1928) (personal residence converted into rental property); *Avco Mfg. Corp.*, 27 T.C. 547, 556 (1956) (cost basis of property received in an exchange); *Ambassador Petroleum Co.*, 28 B.T.A. 868, 873 (1933); *rev'd on other grounds*, 81 F.2d 474 (9th Cir. 1936); CODE § 1053 (property acquired before March 1, 1913. *Cf.* Reg. § 1.167(f)-1 (1956) (basis for depreciation of personal residence converted to rental property). In the absence of special provisions as to basis, which provisions appear in Subchapters C (CODE §§ 301-95, relating to corporate distributions and adjustments), K (CODE §§ 701-71, relating to partnerships), O (CODE §§ 1001-111, relating to gains and losses on disposition of property), and P (CODE §§ 1201-49, relating to capital gains and losses), the basis of property is the cost of such property. CODE § 1012.

8. Reg. §§ 1.167(a)-5 (1956) (after a purchase for a lump sum), 1.334-1(c)(4)(viii) (1955), as amended, T.D. 6298, 1958-2 CUM. BULL. 138 (after a Kimball-Diamond liquidation), 1.358-2(a)(2), (a)(3), (b)(2) (1955) (after a tax-free reorganization exchange).

9. CODE § 368(a)(2)(B) (qualification as a "C" type reorganization).

10. CODE §§ 341(c)(1)(A), (e)(1)(C), (e)(8).

11. CODE §§ 542(a)(2), 543(a)(6).

12. CODE §§ 552(a)(2), 6035(b) (foreign personal holding company); CODE §§ 851-(b)(4), (e)(1) (regulated investment company); CODE § 856(c)(5) (real estate investment trust).

13. CODE § 267(b).

14. CODE §§ 1235(d) (sale of patents), 1239(a) (sale of depreciable property). See also CODE §§ 302(b)(2) (redemption of stock), 304(c) (redemption through use of related corporations), 306(a)(1)(A) (disposition of § 306 stock, 318(a)(1)(C) (attribution of ownership under Subchapter C).

15. In addition, the allocation of earnings and profits after a spin-off depends upon the fair market value of the property involved, Reg. § 1.312-10(a) (1955), as do certain limitations on net operating loss carryovers, CODE §§ 382(a)(1), (b)(1)(B), (b)(2).

ELEMENTS OF FAIR MARKET VALUE

Definition

Notwithstanding the obvious importance of fair market value in our tax structure, there is no place in the Internal Revenue Code, as voluminous and detailed as it has become, which defines the term. The reason for this is obvious, since everyone, including Congress in its frequent use of the phrase, knows what it means — or at least thinks so.

Fair market value is the price at which a sale would take place between a willing seller and a willing buyer dealing at arm's length in a free market, neither being under compulsion to deal and both having reasonable knowledge of the material facts.¹⁶ Like so many concepts in our tax structure, and elsewhere in the law, there is no disagreement about the definition. The real difficulty arises in applying it in the particular case. Thus, the problems which arise regarding the fair market value of property are not so much conceptual as practical, not so much problems of principle as problems of proof.¹⁷

Recognizing that fair market value involves more problems of proof than of principle, it is necessary that one examine the elements of the classic definition if for no other reason than to know what kinds of evidence are pertinent.

Market Requirement

In considering the market requirement in the definition of fair market value, it should be noted that different concepts and methods are involved, depending on whether the item to be valued is property traded on an organized exchange, such as a securities or commodities exchange, property not sold frequently enough or in such volume to be listed on an exchange, or property sold infrequently, if at all.

In the case of property such as stocks, bonds, or commodities traded on an active, organized market, the problem of establishing fair market value can be comparatively free of complications. In such a case, a well-defined, actual market exists. Thus, if the value of one hundred shares of General Motors Corporation stock were at issue, the quoted selling price per share on the New York Stock Exchange as of the applicable date would suffice.¹⁸ Such property is fungible enough that sales of other such shares is presumptive evidence of the price that could be obtained for the particular stock.

This protection is applicable even if shares of the same stock in ques-

16. Reg. §§ 1.170-1(c) (1958) (income tax), 20.2031-1(b) (1958) (estate tax), 25.2512-1 (1958) (gift tax).

17. *Whitlow v. Commissioner*, 82 F.2d 569 (8th Cir. 1936).

18. *Estate of Leonard B. McKitterick*, 42 B.T.A. 130 (1940); Reg. §§ 20.2031-2(b), 25.2512-2(b) (1958).

tion were not traded on the relevant date, so long as they were traded within a reasonable period before and after such date.¹⁹ The presence of a large number of buyers and sellers dealing at arm's length through such an exchange establishes a "market" based on actual sales and thus a method of determining value which is generally considered reliable.²⁰

It must be recognized however, that even in the above situations, the assumption is made that the property was sold at a time when, in fact, it was not sold.²¹ This requires the further assumption that the property to be valued is substantially similar to the property actually sold.²² In the example of the General Motors stock, this is not a serious problem. But if a less active stock, or property sold only infrequently, were involved, this assumption of similarity may be of questionable validity. Consequently, great care must be taken in assuming a market. Even in the case of listed securities, the number of actual sales or the breadth and depth of the market may be too limited to afford sufficient grounds to assume that market price establishes value.²³ Thus, if only a few actual sales were made on the relevant date, there may not have been "enough competition between buyers and sellers to prevent the exigencies of an individual from being exploited."²⁴ Similarly, where the number of shares to be valued is of such size that supply exceeds evidence of demand, the existing market price may not be a proper indication of the price that would be received if the property were actually sold.²⁵

Similar problems arise in the valuation of property other than securities as, for example, real estate, where evidence of sales prices of other parcels is significant only to the extent that such other property is substantially similar to that in question.

In determining the fair market value of property which is not actively traded on an organized exchange and which is sold only infrequently, the complications increase. In this situation, expert testimony²⁶ is generally relied on to establish the price at which the property would change hands if there were a market; that is, if there were numerous sales and willing and knowledgeable buyers and sellers available. In substance, this en-

19. Reg. §§ 20.2031-2(b), (d), 25.2512-2(b), (d) (1958).

20. Estate of Leonard B. McKitterick, 42 B.T.A. 130 (1940); Gordon, *What Is Fair Market Value?*, 8 TAX L. REV. 35, 37 (1952).

21. "[T]he test is hypothetical in that it assumes a sale when there has been no sale but only a gift." *Whittemore v. Fitzpatrick*, 127 F. Supp. 710, 715 (D. Conn. 1954). Cf. *Whitlow v. Commissioner*, 82 F.2d 569, 572 (8th Cir. 1936); *Helvering v. Walbridge*, 70 F.2d 683, 684 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).

22. *Heiner v. Crosby*, 24 F.2d 191, 193 (3d Cir. 1928).

23. *Ibid.*; Reg. §§ 20.2031-2(e), 25.2512-2(e) (1958).

24. *Helvering v. Walbridge*, 70 F.2d 683, 684 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).

25. See discussion of "blockage" at 184 *infra*.

26. E.g., *Whittemore v. Fitzpatrick*, 127 F. Supp. 710, 715 (D. Conn. 1954); *James Couzens*, 11 B.T.A. 1040 (1928).

deavor is directed toward establishing the *intrinsic worth* of the property, because a true "market" does not exist.²⁷ Thus, in valuing stock of a close corporation not listed on an exchange and not frequently traded, some of the factors to be considered are earning power, production, sales, management, and position in industry.²⁸ Restrictions on the use or disposition of such property must also be considered.²⁹ In valuing a partnership or other interest in a business, the approach is similar, considering in addition the underlying asset value.³⁰ In none of the above situations, however, are non-commercial or subjective considerations to be taken into account.³¹

Implicit in the introduction of such evidence is the premise that the price paid for the property on the hypothetical market would be its intrinsic worth. This assumption in turn depends on the supposition that buyers and sellers would exist in sufficient numbers, with sufficient knowledge of the material facts, and with sufficient willingness to deal, so that the price achieved would in fact represent intrinsic worth.

Thus, where the property to be valued is sold with such frequency and in such volume that it is listed on an exchange, such exchange constitutes a "market" based on actual sales. The valuation problem is therefore essentially one of establishing the similarity of the particular property to that actually sold. Where, however, the property to be valued is not sold frequently and is not listed on an exchange, the problem is difficult and generally requires expert testimony as to the significance of limited sales, if they exist, as well as to earning power and similar factors tending to establish intrinsic worth, which, it is assumed, would be the "market" price if a market actually existed.

Fairness Requirement

The requirement of fairness is raised primarily in situations where there is a conflict between intrinsic worth and actual sales prices based either on an existing, active market such as a stock exchange or on a putative market derived from limited transactions. For example, stock prices quoted on major exchanges do not necessarily bear any relation to the intrinsic worth of such stock. On occasion, the taxpayer has argued that the stock market quotations should be disregarded in favor of in-

27. *Helvering v. Kendrick Coal & Dock Co.*, 72 F.2d 330 (8th Cir. 1934), *cert. denied*, 294 U.S. 716 (1935).

28. *James Couzens*, 11 B.T.A. 1040, 1169-72 (1928); Reg. §§ 20.2031-2(f), 25.2512-2(f) (1958); Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.

29. *E.g.*, *Kline v. Commissioner*, 130 F.2d 742 (3d Cir. 1942). *Cf.* *Gary Black*, 38 T.C. No. 68 (Aug. 22, 1962), disallowing a loss deduction on the sale of real estate on the ground that the decline in value was due to restrictive covenants imposed by the taxpayer-vendor.

30. Reg. §§ 20.2031-3, 25.2512-3 (1958).

31. *Whittemore v. Fitzpatrick*, 127 F. Supp. 710, 715 (D. Conn. 1954).

trinsic worth, which is usually lower.³² In such a situation, the courts are not likely to give recognition to this argument.³³ Although

it may be irrational for buyers on the stock market to pay more for a stock than the per share value of the underlying corporate assets, [the courts] are concerned only with what that stock will fetch on such a market even though it be irrational.³⁴

One of the most striking illustrations of this problem arose out of the McKesson & Robbins scandal.³⁵ For several years a corporate official had been recording non-existent inventories on the books. The taxpayer contended that the prices at which McKesson & Robbins stock was traded on the New York Stock Exchange was therefore substantially in excess of intrinsic worth and should be disregarded. The court refused to do so. In support of the court's holding, it must be pointed out that the stock could have been sold for the "market" price, whether or not such price was fair, and thus it was not unfair to impose the tax on that basis.

Contrasted to the above situation is the one where the property to be valued is not traded on an exchange, although similar property is sold on occasion. Thus, in the case of insurance policies, and more particularly, single-premium life insurance policies, it has been held that the proper measure of value is not the price at which it could be sold — that is, the cash surrender value — but the higher figure of cost, since the latter was the only figure which fairly comprehended all the purposes to which the property could be put, including the right to hold the property as well as to sell it.³⁶

One further situation that bears consideration concerns the valuation of notes. Notes are frequently sold to financial institutions and others. Thus, valuation could be established on the basis of sales prices, since there are numerous willing and knowledgeable buyers and sellers. Nevertheless, for tax purposes, the price at which notes might change hands

32. *E.g.*, *Rogers v. Strong*, 72 F.2d 455 (3d Cir.), *cert. denied*, 293 U.S. 621 (1934) (stock prices during 1929 boom rejected).

33. *Estate of Leonard B. McKitterick*, 42 B.T.A. 130 (1940); *Estate of Millie L. Wright*, 43 B.T.A. 551 (1941) (McKesson & Robbins scandal); *Frank Champion*, 19 CCH Tax Ct. Mem. 253 (1960) (stock issued for presumed consideration which was never paid). *But cf.* *Heiner v. Crosby*, 24 F.2d 191 (3d Cir. 1928), reaching a contrary result where intrinsic value was *higher* than market price.

34. *Estate of Leonard B. McKitterick*, *supra* note 33, at 138.

35. *Estate of Millie L. Wright*, 43 B.T.A. 551 (1941); Gordon, *What Is Fair Market Value?*, 8 TAX L. REV. 35, 37 (1952).

36. "All of the economic benefits of a policy must be taken into consideration in determining its value for gift-tax purposes. . . . Cost is . . . here . . . the only suggested criterion which reflects the value to the owner of the entire bundle of rights in a single-premium policy — *the right to retain it as well as the right to surrender it.*" *Guggenheim v. Rasquin*, 312 U.S. 254, 257-58 (1941). (Emphasis added.) See also *Publicker v. Commissioner*, 206 F.2d 250 (3d Cir. 1953), *cert. denied*, 346 U.S. 924 (1954), holding that the cost to the taxpayer of diamonds of rare magnitude was a proper measure of value for gift tax purposes.