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Property Valuation for Transfer Taxes: Art, Science, or Arbitrary Decision?

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PROPERTY VALUATION FOR TRANSFER TAXES:
ART, SCIENCE, OR ARBITRARY DECISION?

by

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I. INTRODUCTION

The federal transfer tax system, consisting of the estate, gift, and generation skipping transfer ("GST") taxes, is based on the privilege of transferring wealth. Whether these transfers take place during life or at death the federal government exercises its taxing authority. While the various transfer taxes possess numerous differences, they are all a tax on wealth transfer. The basis for the tax is the value of the property transferred. The valuation of property included within the gross estate will continue to be hotly litigated.

Valuation issues, as a result, have a significant impact in the transfer tax system. Valuation is the very essence of these taxes.\(^1\) According to Internal Revenue Code (hereinafter "IRC" or the "Code") sections 2031 (Estate Tax), 2512 (Gift Tax), and 2624 (GST Tax), the applicable tax base is the value of the property being transferred.\(^2\) However, these Code provisions provide little guidance on value determination. It is important to note that while the three transfer taxes are separated within the IRC, the general valuation provisions outlined below are common to all. Accordingly, judicial decisions dealing with one tax area (i.e., estate taxation) are also applicable to others (i.e., gift taxation).

The applicable Treasury Regulations ("regulations") provide more precise guidance than the Code itself.\(^3\) The regulations define value as the "fair market value" of the underlying property. Additionally, the regulations provide specific rules in response to various valuation scenarios. Furthermore, numerous Internal Revenue Service ("IRS") pronouncements, such as Revenue Rulings and Procedures\(^4\) and judicial decisions, usually comprised of Tax Court opinions,\(^5\) provide significant assistance and guidance. However, despite the wealth of sources for valuation determinations, valuation is still very much an art rather than a science. The proper valuation of property is a factual matter and depends heavily on the facts and circumstances of the case. Valuation is inherently subjective,\(^6\) and, as a result, there are a number of inconsistencies apparently dependent on differing factual situations.

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4. Probably the most significant of the various Revenue Rulings in this area is Rev. Rul. 59-60, 1959-1 C.B. 237 (Valuation of Stocks and Bonds).
5. Valuation is essentially a factual question. As a result the vast majority of the opinions addressing this issue are Tax Court Memorandum Decisions.
II. OVERVIEW

As transfer taxes are a tax on the privilege of transferring property, it is the value of this property that comprises the underlying tax base. The estate tax is based on the value of the "taxable estate", a figure derived from the "gross estate." The gross estate is defined as the date of death value of all property wherever situated in which the decedent possessed an interest. The gift tax is imposed on the value of the property transferred, as of the date of the gift. However, one must consult the underlying regulations for a more detailed discussion of property valuation.

According to the regulations, the value referred to in the IRC is defined as "fair market value." Fair market value is itself defined 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 nor sell, and both having reasonable knowledge of relevant facts." The so-called hypothetical "willing buyer/seller" standard is prevalent throughout the case law dealing with this issue. Given the importance of this standard, additional discussion is warranted.

The standard requires an analysis of both sides of the transaction. It is not appropriate to focus solely upon what someone would pay for the property or for what price someone would sell it. Rather, one must look at both sides of the transaction. In the decisions discussed below, courts criticize both parties for having failed to look at the buyer's and seller's positions. Furthermore, the hypothetical buyer and seller are just that — hypothetical. One should not attempt to focus on a particular buyer or seller, such as family members or corporations. The hypothetical buyer and seller are also presumed to deal at arm's length.

7. I.R.C. § 2031(a) (1994). Note that IRC § 2032 allows the personal representative of the estate to elect a valuation date six months after the decedent's death. See I.R.C. § 2032 (1994). If the election is made, it applies towards all property. Additionally, property disposed of during the intervening six months is valued as of the date of disposition. Finally, an election under this section is only allowed if it would decrease the valuation amount and result in a lessened estate tax liability. I.R.C. § 2032(c) (1994).
13. The willing buyer (and seller) is a purely hypothetical figure and the valuation does not take into account the personal characteristics of the actual recipients of the property.
Additionally, the standard requires that neither party be under any compulsion to buy or sell. This prevents forced sales or liquidation values from being considered probative evidence. However, there are exceptions for sales pursuant to a binding and reasonable buy-sell agreement. Furthermore, the sale is determined by reference to the market in which the property is commonly sold.

Finally, both parties are presumed to have knowledge of all relevant facts. Neither the buyer or seller possesses "inside" information. Moreover, only those facts reasonably known at the valuation date are presumed to have been known by the hypothetical parties. Subsequent facts and events are generally not considered within the valuation process, unless reasonably anticipated and foreseeable on the valuation date.

As in most other tax matters, the burden of proof is upon the taxpayer. In both the notice of deficiency and denial of refund claim, the determination of the IRS carries a presumption of correctness. The taxpayer must overcome this presumption by a preponderance of the evidence. However, the IRS bears the burden on any new matter not raised in the statutory notice of deficiency or refund denial.

Finally, the taxpayer's failure to meet his or her burden may result in more than an increased tax liability. The Code also imposes significant penalties for a substantial valuation understatement. A substantial valuation understatement exists if the taxpayer's reported value is 50 percent or less of the amount determined to be correct through assessment or final court adjudication. According to IRC section 6662, the penalty consists of a 20 percent addition to the resulting understatement of tax. Furthermore, if the reported value is 25 percent or less of the adjudicated value, referred to as a gross

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of Murphy v. Commissioner, 60 T.C.M. (CCH) 645, 651 (1990), citing Estate of Bright v. Commissioner, 658 F.2d 999, 1006 (5th Cir. 1981); See Estate of Pillsbury v. Commissioner, 64 T.C.M. (CCH) 284, 286 (1992).
23. IRC § 6662 (1994).
24. IRC §§ 6662(a), (g).
valuation misstatement, the penalty amount is 40 percent of the additional tax liability.\(^{25}\) An application of the penalty provisions is illustrated below.

John Baker reports a gift value of $100,000, but the actual value was by judicial proceeding determined to be $300,000. Since one half of the adjudicated value exceeds the taxpayer’s reported value ($300,000 x .5 = $150,000 > $100,000), a substantial valuation understatement exists. Additionally, assuming a 50% tax rate, the additional tax liability is $100,000 (($300,000-$100,000) x .5). Accordingly, Baker’s penalty amounts to $20,000 ($100,000 x .2). This results in a liability consisting of the tax on the reported value ($100,000 x .5), the tax on the valuation increase ($200,000 x .5), as well as the penalty amount ($100,000 x .2), for a total of $170,000. If the adjudicated value was $500,000, and not $300,000, the additional tax liability is $200,000 ($(500,000-$100,000) x .5), and the resulting penalty is $80,000 ($200,000 x .4), four times the earlier penalty amount. As a result, Baker’s failure to carry his burden of proof, as in the first example, results in an additional tax liability of $200,000 and a penalty of $80,000.

III. VALUATION STANDARDS AND GUIDELINES

A. Valuation of Business Interests

1. Publicly Traded Stock

The valuation of stocks and bonds has long been looked at as the most difficult area of the transfer tax system.\(^{26}\) This difficulty is most prevalent when dealing with closely and/or privately held stock. However, securities valuation is far less difficult if one is dealing with publicly traded stock. Publicly traded securities possess the advantage of a readily determinable market price, especially if the underlying securities are traded on an established exchange.

The value for stock is computed on a per share basis.\(^{27}\) If there is an established market for the underlying securities, the value is defined as the mean between the highest and lowest quoted selling prices during the valuation date (trading day).\(^{28}\) For example, if on the valuation date, Acme stock was selling between a low of twenty and a high of thirty dollars per share, the transfer tax value would be defined as twenty-five dollars per share. The aforementioned general rule applies only when there are sales occurring on

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25. IRC § 6662 (h).
the valuation date. Thus, broad-market stocks such as IBM will qualify for application of the rule, while securities with thin markets may not qualify, thus presenting valuation problems. Moreover, if the valuation date occurs when there is no market activity, such as a weekend when exchanges are closed, even broad-market securities may present difficulty.

As a result, if there are no sales of the underlying security on the valuation date, the value is determined through a weighted average of the mean sales price for sales occurring immediately before and immediately after the valuation date.\textsuperscript{29} Note that these sales must occur within a reasonable period surrounding the valuation date. The average is inversely weighted by proximity of the sales date to the valuation date. The closer the sales date to the valuation date, the greater the weight given to the sales price. This approach is illustrated in the following example, adopted from the regulations.

Assume that the valuation date is Friday, June 15. Sales of Acme common stock nearest the valuation date are June 13 and June 20 (two trading days before and three trading days after the valuation date). The mean sales prices were $10 and $15 per share respectively. The fair market value of the Acme stock on June 15 is computed as follows: \[(3 \times 10) + (2 \times 15)] / 5 = $12 \text{ per share.}\textsuperscript{30}

Furthermore, if the stock is listed on more than one exchange, the prices of the exchange where the securities are principally dealt should be employed, if readily determinable.\textsuperscript{31} Otherwise, a composite listing may be used. If the sales prices are not readily determinable through a published listing, accurate exchange records should be used. If the securities are not listed on an exchange, evidence of sales prices should be attached to the filed return. Such evidence may consist of quotations or letters from brokers, as well as from officers of the issuing corporation.\textsuperscript{32}

Finally, if actual sales prices of the securities are not available during a reasonable period surrounding the valuation date, the regulations call for the use of bona fide bid and asked prices. The value of the underlying security is defined as the mean between the bid and asked prices on the valuation date.\textsuperscript{33} If there are no bid and asked prices available for the valuation date, the value is determined through a weighted average, similar to the example above, of the nearest trading dates within a reasonable period before and after the valu-

2. Debt Instruments

The fair market value of debt instruments, such as bonds, notes, or bills, is presumed to be the amount of the unpaid principal and accrued interest as of the valuation date. This presumption may be overcome only by a strong showing by the estate or grantor of a lower value or that the instrument has become worthless. Even with a showing of worthlessness, the taxpayer must still present evidence that any property securing the debt is insufficient.

The reduction in value, or discount, of the debt may be supported by a number of factors. For example, inadequacy of the underlying security, arrearage of payments, and risk of default are commonly accepted grounds for discounting a debt instrument. Additionally, a significantly understated interest rate, given the characteristics of the debt, is also a basis for discount. The fair market value of the debt is the present value of the principal and interest payments, discounted by a determined market rate. The determined rate incorporates all of the above factors, as well as additional provisions such as lack of covenants, default provisions, marketability of the debt, subordination, and comparison to similar debt instruments.

3. Closely or Privately Held Stock

Corporate stock that is not publicly traded poses one of the most challenging obstacles to valuation. Unlike listed shares, privately held stock does not possess a readily determinable market price. As a consequence, valuation of stock that is closely or privately held constitutes the largest area of valuation cases and IRS pronouncements.

The general valuation guidelines are set forth in IRC section 2031(b). According to the statute, the value of unlisted stock or securities is to be determined by taking into consideration the value of stock or securities of corporations engaged in the same or similar line of business which are listed on an exchange. Thus, this statutory provision mandates the use of a comparable market analysis. However, the statute does not forestall use of additional valuation methods. The statute explicitly refers to other factors in addition to comparable analysis. Moreover, various comparable analysis methods are available as well.

36. Estate of Friedberg, 63 T.C.M. (CCH) at 3081.
37. Id.
38. Id.
39. Id.
The reference in section 2031(b) to other factors is expanded in the accompanying regulations. Two sets of factors are described in the regulations, depending on whether the item being valued is equity or debt. If the underlying asset is debt, consideration of the soundness of the security, the interest yield, and date of maturity are to be considered. If the asset is equity, consideration is required of the company’s net worth, prospective earning power, and dividend paying capacity. In addition, other relevant, but unnamed, factors should be identified and utilized. One extremely significant factor to be considered is the general economic outlook on the valuation date. These other factors lead to the various valuation methods identified below.

The IRS promulgated a series of revenue rulings and procedures in the valuation field. The most significant ruling is Rev. Rul. 59-60.40 This ruling is considered to be the most influential ruling in the business valuation area, and its influence has extended to other valuation problems. The ruling enumerates a number of significant factors, although it does not foreclose consideration of others. These factors include: the nature and history of the business, general and industrial economic outlook, book value and financial condition, earning capacity, dividend-paying capacity, the existence of goodwill, prior sales of stock and the size of the block in question, and the market price of comparable business firms.41

The predominant methods relied upon in determining asset valuation are the following: capitalization of earnings, net worth or asset value, comparative sales analysis, discounted cash flows and actual sales. The ‘net asset value’ method also incorporates the computation of the firm’s liquidation value. Additionally, comparative sales analysis, as mandated by section 2031 and it’s accompanying regulations, encompasses a number of variations. Two very common variations are the use of comparable firms’ price/earnings (P/E) ratios and the market/book ratios. Finally, the ‘actual sales’ method refers to the use of actual sales of the underlying security, ideally an arm’s length transfer near the valuation date. The above methods are the most prevalent, but are not the exclusive methods adopted. Other, less frequently utilized methods are the capital asset pricing model (CAPM) and the Black-Scholes (B/S) option-pricing formula. These valuation methods are each discussed below.

The method that most closely determines the true value of the underlying security must be utilized. Because the taxpayer has the burden of proof, he or she must demonstrate that the method used is the best one. As indicated by the cases, taxpayers usually rely on a combination of methods and use a

41. Id.
weighted average to compute the final value. In doing so, the taxpayer is required to demonstrate the propriety of both the method used and the weights assigned. Above all, the taxpayer must take care in applying the methods utilized.

While a number of accepted methods exist, there are limitations on which methods are acceptable for a particular case. One significant limitation depends upon whether the activities of the underlying firm are classified as 'operating' or 'investing.' When valuing operating companies, courts consistently favor the use of earnings and dividends. However, courts typically rely on net asset values and worth when valuing investing companies. According to the Tax Court, when valuing stock of an operating company, primary consideration should be given to earnings, whereas valuation of a holding or investment company requires valuation of the underlying assets. The rationale for this distinction is that holding or investment companies are created to build up capital appreciation over time and de-emphasize regular cash flow. A buyer of such a company would be principally concerned with the value and potential appreciation of the underlying assets and would not be concerned with short-term dividend paying capacity.

An investment or 'holding' company is classified as a firm that is not an operating company and limits its activities to the holding of real estate or other investment assets. An operating company is a firm that is actively engaged in the production and generation of income, such as a manufacturer. There are, however, instances where a firm lies in a gray area and is both an investment and an operating company. The Tax Court encountered an example in Estate of Andrews where the classification of a real estate management firm was at issue. The firm in Andrews was primarily involved in the ownership, management, and operation of commercial real estate properties. The court acknowledged the difficulty of classification and applied a hybrid of both the 'asset value' and 'earnings' valuation methods.

While specific valuation methods are preferred for specific classes of firms, the proper classification of the firm in question is far from easy. The vast majority of business firms in the economy are hybrid operating/investment companies. While there are firms that are solely operating or investing, they are the exception and not the rule. Accordingly, a combination of methods must be utilized. The degree to which a corporation is actively engaged

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44. Id.
45. Id. at 1512.
in producing income rather than merely holding property for investment should influence the weight given to values arrived at under different approaches. However, it should not dictate the use of one approach to the exclusion of all others.\textsuperscript{47} As stated above, courts are extremely reluctant to rely on a single valuation model, although they might afford one model significantly more weight in the final determination. The statutory provision in the IRC specifically mandates consideration of all relevant factors. Accordingly, classification of the firm whose securities are being valued is important in determining which methods of valuation are paramount, but it is not determinative.

The predominant methods enumerated above usually require the service of an expert. Because of the heavy reliance on experts in this area, it is important to obtain an appraisal of the securities prior to filing the appropriate return. An accompanying appraisal will not guarantee acceptance of the reported valuation, but it will provide ammunition against later IRS attacks. Additionally, one should note that under IRC section 7517, the taxpayer is entitled to a copy of the government's appraisal of value. However, by furnishing the appraisal, the government is not precluded from changing its valuation and producing a new appraisal.

Although the IRS employs their own valuation engineers, it frequently hires outside experts.\textsuperscript{48} Taxpayers also rely heavily on expert testimony and appraisals. Frequently, valuation cases turn into a "battle of the experts." Both sides present expert testimony and appraisals supporting their valuation estimates. The court is then required to extract from the opposing opinions a just and final determination.

The final valuation of the gross estate is to be determined based on all relevant evidence and any appropriate inferences that may be derived from that evidence.\textsuperscript{49} Included within the definition of relevant evidence are the parties' respective expert opinions. Expert opinion evidence is evaluated in light of the qualifications of the expert and other evidence of value. Relevant expert qualifications include familiarity with the subject matter being valued, as well as experience and education in valuation and appraisal techniques. Proffered experts have included law and business school faculty, accountants,

\textsuperscript{47} Id. at 945.

\textsuperscript{48} The Internal Revenue Service utilized outside experts in a number of cases including: \textit{Estate of Ford}, 66 T.C.M. at 1514; Hutchens Non-Marital Trust v. Commissioner, 66 T.C.M. (CCH) 1599, 1613 (1993); Estate of Jung v. Commissioner, 101 T.C. 412, 429 (1993); Estate of Newhouse, 94 T.C. 193, 205 (1990) (experts consisting of law professors from such schools as Harvard and Columbia). Meanwhile the Internal Revenue Service also utilizes their own staff. \textit{Estate of Oman}, 53 T.C.M. at 68.

\textsuperscript{49} Estate of Feldmar, 56 T.C.M. (CCH) 118, 127 (1988).
economists, financial analysts and professional appraisers. However, despite the qualifications of the expert, the court is not bound by his or her opinion. The court may accept, modify, or reject expert opinion testimony as it, in its judgment, deems appropriate. Courts may even rely on an expert's criticism of another expert's opinion, while still rejecting the substance of the report.\textsuperscript{50} The courts in non-jury forums, such as the Tax Court and Court of Federal Claims, have great leeway in weighing expert testimony. Additionally, the court may combine portions of conflicting testimony to arrive at its determination, or it may completely reject the proffered testimony and make its own determination.

\textit{a. Net Asset Value/Net Worth Method}

The net asset value method is one of the two most prevalent valuation methods. As mentioned above, it is the preferred method when valuing investment or holding company securities. Generally, this method determines the fair market value of the firm's assets, minus liabilities, and assigns that value to the firm itself. The security in question is valued as a portion of the total net asset value of the firm. Essentially, the firm is valued at its net worth, as illustrated below.

For example, XYZ Company has the following attributes: cash ($50,000), inventory ($350,000), investment securities ($100,000), real estate ($500,000), and issued bonds ($600,000). The net asset value of XYZ Company is $400,000 ($50,000 + $350,000 + $100,000 + $500,000 - $600,000). A twenty percent interest in XYZ Company is worth $80,000 ($400,000 x .2). However, as will be seen later, this value is without any allowance for valuation premiums or discounts. Additionally, the value of the firm's individual assets and liabilities, such as investment securities and real estate, is often subject to differing opinions.

The first step in applying this method is identifying the key underlying assets. For a real estate firm these would be the land and improvements owned by the firm. Valuation of the real estate may require an appraisal, reference to sales of comparable properties, or property tax assessments. For an investment company, it would be the underlying securities.

For investment or holding companies, the valuation of the underlying assets, typically securities, may present the same problems as unlisted stock or bonds. This often requires valuing the securities held by the firm in question, possibly by using a separate valuation method.\textsuperscript{51} For example, assume Acme Holding company owns 80 percent of the stock of Smith Incorporated,

\textsuperscript{50} Estate of Mueller v. Commissioner, 63 T.C.M. (CCH) 3027, 3027-33 (1992).
\textsuperscript{51} Estate of Ford, 66 T.C.M. (CCH) 1507, 1515 (1993).
an operating company. The value of the Acme stock, using the net worth method, requires the valuation of the Smith stock, using another method such as capitalization of earnings. However, while the holding company stock may be unlisted and difficult to value directly, the underlying stock may be publicly traded. For example, in Estate of Piper,\(^5\) the assets of the two holding companies consisted of publicly traded Piper Aircraft Corporation stock.

There are additional means of asset valuation. As stated earlier, local property tax assessments, recorded book value, and independent appraisals may be used. Additionally, industry valuation guides, such as the NADA guide for valuing used automobiles, contain commonly accepted asset values. As a result, reference to financial statements, tax records, industry dealers, and trade publications are common. The ultimate goal is to determine a total value for the firm’s net worth, and then, to allocate a proportionate share to the securities in question (absent any discounts or premiums). For example, a 70 percent interest is allocated 70 percent of the firm’s net worth.

\textit{b. Capitalization of Earnings}

The next method, capitalization of earnings, is commonly used when valuing operating firms. This method entails valuing a firm based on the present value of its future earnings.\(^5\) The assumption is that an investor would be primarily concerned with the company’s earning capacity. Accordingly, this method is not useful in valuing holding or investment companies, as they generate minimal earnings and focus on asset appreciation. Under the capitalization of earnings method, the earnings of the firm are projected into the foreseeable future, assuming a certain rate of growth. This represents the firm’s projected income stream. The projected income stream is then discounted by a determined rate to compute the estimated value. The Tax Court utilized such a procedure in Estate of Oman.\(^5\) Earnings for the firm in Oman were projected ten years into the future, assuming a 10 percent annual growth rate. The present value of this income stream was computed using a discount rate of 1.5 times the “riskless” rate (market rate on government securities) to arrive at the estimated equity value for the firm.\(^5\) Note that the use of this method requires the determination of an earnings growth rate as well as a discount rate.\(^5\) A similar procedure is available involving cash dividends.

\(^{52}\) Estate of Piper v. Commissioner, 72 T.C. 1062, 1072 (1979).

\(^{53}\) Hutchens Non-Marital Trust, 66 T.C.M. (CCH) at 1611-12.

\(^{54}\) Estate of Oman, 53 T.C.M. (CCH) 52, 65 (1987).

\(^{55}\) Id.

c. **Discounted Cash Flows**

The discounted cash flow ("DCF") method is conceptually similar to the capitalization of earnings approach. The calculations are essentially the same. The DCF approach involves calculating the sum of the present value of the available cash-flow and the present value of the terminal value.\(^5^7\)

Valuation under the DCF method requires the computation of the present value of the estimated future cash-flow. First, the available cash-flow of the business is determined for a certain projection period. Second, a discount rate is applied to determine the present value of the cash-flow. Third, the residual value (assets minus equity) of the business at the end of the projection period is determined. Fourth, the present value of the residual is computed. Finally, the two computed present values are added to determine the value of the business.\(^5^8\) The projection of cash flows, like earnings, requires consideration of future expenses and capital expenditures.

The two essential elements of this method are the projected cash flow stream, usually derived from computed growth rates or econometric models, and the discount rate, usually the firm's cost of capital. The choice between cash flow and earnings is akin to the choice between cash and accrual accounting. Earnings may theoretically be a more accurate measure of value, but cash flow is what an investor eventually anticipates receiving.

d. **Comparative Market Analysis**

The statute, regulations, and IRS pronouncements all require consideration of publicly traded securities of comparable firms if such information is available. Essentially every judicial decision refers to this requirement, and practically every expert opinion addresses the issue. The paramount issues in comparative analysis are which companies are comparable to the one in question, and how comparable they are. Frequent disputes arise between the government and the taxpayer over the accuracy of the parties' comparative corporations.

Given a group of comparable firms, there are a number of different analyses. Among the most prevalent are current and historical price/earnings (P/E) ratios as well as market to book value of equity. The use of P/E ratios is the most common method. Additional variations include use of comparative dividend yields or market to book value of sales or cash flows.

The use of P/E ratios, or ratios of stock price to earnings per share, require the determination of such ratios for a comparison group of firms. These ratios are combined into an "adjusted average" and applied to the earnings of

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58. Id. at 424.
the firm in question. For example, the Tax Court in *Estate of Lauder*,\(^5^9\) utilized a comparative analysis using price/earnings ratios of comparable publicly traded firms. The chosen firms were all engaged in the cosmetic industry, as was Estee Lauder Inc. ("EJL"), and were publicly traded. The analysis included computing P/E ratios for each of the firms, comparing each firm's ratio with that of EJL, and determining the relative position of EJL's ratio.\(^6^0\) Avon, for example, had a P/E ratio between 20.7 and 17.7, which was determined to be substantially higher than EJL's, while Helen Curtis' ratio range of 6.1 to 7.2 was found to be below EJL's. The determination of EJL's P/E ratio required a comparison with industry counterparts as well as consideration of the relative strengths and weakness of the sample firms and EJL. Following the comparisons, EJL was estimated to trade at a price between 9 and 9.5 times its reported earnings. EJL's estimated trading price was between $2,025 and $2,727 per share, an amount based on reported earnings between $7,855,000 and $10,021,000.\(^6^1\) A similar procedure could be applied using the ratio of book value to market value.

e. Actual Sales

Courts are in general agreement that the best evidence of a stock's value are actual sales of the same stock within a close proximity to the valuation date.\(^6^2\) However, such sales must be of the same, or extremely similar, security with no significant intervening events between the sale and the valuation date that could alter the value. Additionally, the sale must be at arm's length, indicating the sales price approximates fair market value.\(^6^3\) Failure of these requirements and evidence of the sale carries little, if any, probative value. Examples of such disqualifications include sales between family members, sales occurring over six months before the valuation date, sales under unusual circumstances, and forced sales. Additionally, sales taking place before an intervening significant event, such as bankruptcy, are also suspect.

f. Other Methods

A number of other methods are utilized in valuation cases. While the predominant ones are discussed above, two additional methods are occasionally used. These are the capital asset pricing model (CAPM) and the Black-Scholes option pricing model.\(^6^4\) The CAPM is a capitalization model based

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60. Id.
61. Id.
on a linear regression of the firm's return (stock price) on an indexed market return, such as the Standard and Poor's 500 or Dow Jones Industrial Average. Meanwhile, the Black-Scholes model uses an option pricing model, treating the firm's equity as an option on the firm's assets. Note both models are infrequently used, and the Tax Court has been very reluctant to accept the Black-Scholes model.\textsuperscript{65}

Valuation of unlisted stock comprises the largest source of valuation disputes between the government and the taxpayer. However, through proper use of the above methods, a satisfactory resolution can be obtained. Additionally, unlisted stocks are not the only areas of dispute. Partnership interests are another source of valuation disputes.

4. Restrictive Sale Agreements

Determination of fair market value is often a complicated task, calling for numerous computations and judgments. However, there is a narrow instance where the computation of market value is not required. This situation constitutes an exception to the general rule that property is taxed on its fair market value on the valuation date. This exception results from a valid restrictive sales agreements. The Estate Tax Regulations contemplate the use of restrictive sales agreements and their possible effect on value.\textsuperscript{66} If the agreement is valid, the market value for tax purposes is equal to the execution price set forth in the agreement. Such agreements are not uncommon in closely held corporations or partnerships. The regulations recognize that shares are often subject to corporate buy-sell agreements, redemption provisions, or shareholder agreements. Additionally, partnership agreements often provide for a buy-out price.

The general rule is that such agreements are ignored unless they meet the three requirements set forth in IRC section 2703(b). First, the agreement must be a bona fide business arrangement. Second, it must not be a device for a testamentary disposition, that is, a device to transfer such property to a family member for less than full and adequate consideration. Finally, the agreement must be entered into pursuant to an arm's length transaction.\textsuperscript{67} Additionally, for the agreement to be binding for estate tax purposes, it must be binding during the decedent's life.\textsuperscript{68} For the contract to be binding, the estate must be legally bound to sell the stock at the agreed price and must not be free to

\textsuperscript{65} ld. at 1617. \textit{See also}, Estate of Cidulka, 71 T.C.M. (CCH) 2555 (1986) (use of net sale multiplier).


receive any price greater than that set forth in the agreement.\textsuperscript{69}

Restrictive sales agreements have been upheld for estate tax purposes in the partnership context. The Tenth Circuit addressed an agreement that provided for the purchase of a deceased partner’s interest at its book value.\textsuperscript{70} The agreement was binding during the decedent’s life, as well as after his death. Additionally, the agreement in question was specifically enforced in a state probate court proceeding. While the market value of the partnership interest was higher than its book value, the interest was still encumbered by the agreement. As a result, the book value was the total value of the interest to the estate.\textsuperscript{71}

The three essential requirements set forth in section 2703 have been subject to judicial elaboration. Generally, the price set forth in the agreement must be reasonable, or at least had to have been reasonable when the agreement was made. The use of book value is common in such agreements because it is quick and easy to compute by reference to the firm’s financial statements. An agreement that provides for a yearly review of the execution price has also been upheld.\textsuperscript{72} Also, a formula price may be utilized. The price eventually agreed upon must be supported by a valid business purpose and reached through arm’s length negotiations. However, if the agreement price is excessively below fair market value, concerns are raised about the legitimacy of the agreement.

The relationship of the parties is an extremely important factor. Restrictive sales agreements among family members receive special scrutiny. Family members usually do not deal at arm’s length. In addition, the participation of close family members raises questions as to whether the agreement had a valid business purpose, or alternatively, whether it was a testamentary disposition. Courts have upheld agreements involving family members where they possessed adverse interests or sought enforcement in a judicial proceeding.\textsuperscript{73} However, the Tax Court rejected an agreement where the parties were related, and there was no evidence of adverse interests or a mutually agreed upon price.\textsuperscript{74} The Court rejected the agreement because the formula price was chosen by one individual without consulting the other parties. Thus, there was no arm’s length transaction and no rationale for the valuation method chosen.\textsuperscript{75} Also, the formula price produced a value less than half the market value.

\textsuperscript{69} Estate of Carpenter v. Commissioner, 64 T.C.M. (CCH) 1274, 1278 (1992).
\textsuperscript{70} Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955).
\textsuperscript{71} Id. at 896.
\textsuperscript{73} Hutchens Non-Marital Trust, 66 T.C.M. (CCH) 1599, 1623 (1993); Gore, 224 F.2d at 895.
\textsuperscript{74} Estate of Lauder, 64 T.C.M. (CCH) 1643, 1658-61 (1992).
\textsuperscript{75} Id. at 1658.
when the agreement was signed.\textsuperscript{76}

In addition to an agreement’s terms, courts will generally look at the events surrounding the execution of the agreement to determine its validity.\textsuperscript{77} The execution price should bear some reasonable relationship to market value on the date of execution. Additionally, the agreement should have been negotiated at arm’s length, with an expressed business purpose. However, the continuation of a family run business is considered a valid business purpose, even though it is inherently testamentary.\textsuperscript{78} Factors usually considered include the purpose of the agreement, relationship of the parties, and derivation of the agreement price. Finally, consideration is also given to any significantly changed circumstances between the date of the agreement’s execution and the valuation date.\textsuperscript{79}

5. Other Business Interests

As mentioned previously, partnerships and proprietorships are common forms of business ownership. The valuation of these interests present many of the same problems, and solutions, as encountered in valuing unlisted stock. Partnership interests are not freely tradeable, and, as a consequence, there is no readily determinable market price.\textsuperscript{80} The general guidelines for valuing partnership interests, as with other forms of business ownership, require consideration of the net amount at which a willing buyer would pay to a willing seller for the interest in question.\textsuperscript{81} Specifically, the following three factors, in addition to other relevant facts, are to be considered: a fair appraisal of the business’ tangible and intangible assets, demonstrated earning capacity, and consideration of the applicable corporate valuation factors.\textsuperscript{82} Additionally, explicit reference is made to consideration of goodwill. Goodwill, generally the excess a buyer would pay over the market value of the net assets, includes such items as established customer base, business reputation, and trained work force.

Overall, as mentioned in the regulations, use of the same valuation methods and principles used in valuing corporate stock is warranted in the

\textsuperscript{76} Id. at 1661.
\textsuperscript{77} See Rudolph v. United States, 93-1 U.S. T.C. \textsuperscript{16} 88, 448 (S.D. Ind. Feb. 5, 1993).
\textsuperscript{78} Estate of Lauder, 64 T.C.M. at 1657.
\textsuperscript{79} See Rudolph, 94 U.S. T.C. at \textsuperscript{16} 88, 449.
\textsuperscript{80} However, master limited partnerships serve as a minor exception. Unlike traditional partnerships, these relatively new entities provide for public trading of their limited ownership interests.
\textsuperscript{81} Treas. Reg. §§ 20.2031-3 (1995), 25.2512-3 (1995). The provisions of these regulations are applicable to all business interests, including sole proprietorships and partnerships.
case of a partnership. Although a comparable sales analysis would not be applicable unless the business is comparable to a publicly traded corporation, use of the other approaches is sufficient. The net worth/asset value method is useful for meeting the first requirement of considering the underlying asset values. Use of the capitalization of earnings and discounted cash flow methods are applicable for the second requirement, earning capacity. For example, the Tax Court in Moore v. Commissioner\(^{83}\) relied on a net asset valuation of a partnership interest for gift tax purposes.

B. Valuation of Real Property

Real estate valuation plays a significant role in both transfer and income taxation. Generally, real estate value is based upon an appraiser’s opinion of the value of the underlying property. For purposes of transfer taxation, the general rule of the hypothetical willing buyer and seller applies. However, an additional standard applies for determining real estate value. The fair market value of real property must be determined by reference to its “highest and best use.”\(^{84}\) The current use of the property is irrelevant for valuation purposes. Highest and best use is considered to be the use of the property that results in its highest value. The four criteria to determine the highest and best use are: legal permissibility, physical possibility, financial feasibility, and maximum profitability.\(^{85}\)

The determination requires consideration of social, economic, governmental, and environmental conditions. Social conditions include the makeup of the neighborhood or area in which the property is located. Economic conditions relate to the nuances and structure of the local market, including local supply and demand factors and the current mortgage market. Economic considerations also relate to comparative sales and the relative supply of real property on the market. Economic factors directly affect the property’s financial feasibility and profitability. All of these factors are illustrative of the primary driver for real estate value — location.

Governmental and environmental factors affect the legal permissibility of the property’s use. Zoning laws, easements, rights-of-way, leasehold rights, deed restrictions, and local tax policy are all relevant governmental conditions. Environmental conditions include legal restrictions and obliga-

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85. INTERNAL REVENUE SERVICE, VALUATION GUIDE FOR INCOME, ESTATE AND GIFT TAXES: VALUATION TRAINING FOR APPEALS OFFICERS 3-19 (CCH 1994) [hereinafter Valuation Guide]. Note that the Valuation Guide is an internal IRS document and may not be cited as authority in an administrative or judicial proceeding.
tions imposed by statutory and common law sources. Hazardous and harmful materials are a significant concern, and a limiting factor, in determining property value. For example, the value of property with underground fuel storage tanks is subject to potentially limitless environmental liability. As a result, such property possesses a severely depressed market value.86

Another limiting factor in real estate valuation is the nature and extent of the decedent’s rights in the property. The IRC mandates inclusion of the value of property owned by the decedent to the extent of his interest therein.87 Accordingly, if the decedent owned less than an undivided fee interest, the amount of the inclusion is less than the total value of the property. In this case, it is only the value of his interest that is included. Examples of such limited interests are joint tenancy and community property interests, leased (lessor’s) interests, leasehold (lessee’s) interests, and easement interests. Additionally, the interests of the decedent may be subject to liens, mortgages, or other encumbrances. Certain interests are addressed through particular IRC sections. IRC section 2034 deals with community property interests,88 sections 2036 and 2038 deal with life estates,89 and section 2040 addresses joint interests such as co-tenancy or tenancy in common.90

The actual methods used in valuing real estate follow closely the methodology described above in valuing business interests. There are three recognized approaches to real property valuation: the cost method, the market method, and the income capitalization method.91 The cost approach is based upon the property’s current reproduction or replacement cost, with an allowance for any depreciation for improvements.92 The market approach is essentially a comparative sales approach, based upon sales of like-kind property in the same market.93 This method is generally the preferred valuation approach. The income capitalization method is useful for valuing income producing property such as mineral rights. The technique requires an estimation of anticipated cash flows from the property, which are then discounted to compute the property’s present value.94 The proper value is determined by application of any one, or a combination of, these three methods.

86. Id. at 3-14.
87. IRC § 2033 (1994).
88. IRC § 2034 (1994).
89. IRC §§ 2036 and 2038 (1994).
90. IRC § 2040 (1994).
92. Id. at 4-3.
93. Id. at 4-8; Estate of Stanton v. Commissioner, 57 T.C.M. (CCH) 961, 962 (1989) (generally, comparable sales of similar property represent the best evidence of the fair market value of real estate); Estate of Einsiedler, 67 T.C.M. (CCH) at 2650.
94. Valuation Guide, supra note 85, at 4-17.
As stated earlier, real estate is valued according to its highest and best use. However, the highest and best use may not coincide with the current use of the property. For example, land currently used as farmland may possess greater value as residential property. In such a case, fictional valuation at highest and best use may cause an undue hardship on the present users and owners of the property. As a result, IRC section 2032A provides for special use valuation. Special use valuation allows the property to be valued based on its current use. This section was designed to essentially protect the family farm from having to be sold to pay estate taxes. However, there are a number of restrictions imposed on those seeking to qualify. A large portion of the gross estate must be comprised of "qualified assets," that is, the family farm or business. The property must pass to the decedent's family, who must continue active participation in the farming or business activity for ten years after the decedent's death. Failure to continue active participation results in a recapture of the estate tax savings. Finally, the maximum reduction in value available under this provision is $750,000. The use of this provision allows for a substantially reduced valuation determination, and a lower estate tax liability.

C. Valuation of Other Categories of Assets

There are additional valuation concerns for other categories of assets. Among these are artwork, court judgments, and the value of the decedent's own name. Only a limited number of such assets are addressed below, but the general guidelines and procedures are applicable to many additional categories of assets.

1. Artwork

Artwork presents one of the most challenging and difficult areas of valuation. Unlike business interests, artwork is inherently qualitative and entirely subjective. While corporations and partnerships possess monetary attributes, works of art do not. Unlike shares of stock, individual works of art are both distinctive and unique. The application of across-the-board techniques ignores this uniqueness. As a consequence, artwork receives special consideration. The general "willing buyer/seller" standard of market value applies in the art context, but the agreed upon price is based on subjective preferences. The costs of raw materials, such as paint, plaster, canvas, or sculptured stone, comprise only a small portion of the total value of artwork.

A work of art usually does not have intrinsic financial value beyond its desirability as art and lacks external indicia of return prior to resale. Valu-

95. IRC § 2032A (1994).
97. Id. at 2702.
ation of artworks requires consideration of numerous factors. Criteria that have been considered by the courts include rarity, quality, size, subject matter, medium, and condition. Another significant factor is authenticity of the work, especially if the artist is well respected. Authenticity becomes of particular importance when doubts are raised concerning it. As a consequence, each individual work of art is valued separately and subjectively, using the aforementioned factors and opinions of qualified experts.

Procedurally, the use of expert appraisers is mandated by the estate tax regulations. If the estate includes articles having a marked artistic or intrinsic value in excess of $3,000, an appraisal by a qualified expert under oath must be filed with the return. Also, the personal representative of the estate must, under penalty of perjury, furnish a written declaration attesting to the completeness of the itemized list of such property and the disinterested qualifications of the expert. Examples of items with artistic or intrinsic value include paintings, oriental rugs, antiques, statuary, jewelry, silverware, books, and coin or stamp collections. The accompanying appraisal must also include a general description of the items. For example, an appraisal of a painting must state the size, subject, and artist. However, the use of appraisals does not prevent the government from challenging the reported value. Other factors considered to be relevant include: medium, date created, date and method of acquisition (if not self-created by decedent), ownership history, past exhibitions of the work, sales prices of comparable works of art, and quoted prices in dealers’ catalogs.

The most significant distinction surrounding works of art is the existence of the IRS Commissioner’s Art Advisory Panel. This panel is responsible for reviewing and analyzing artwork with a taxpayer reported value exceeding $20,000. After review, the panel, which is comprised of art experts, submits an appraisal of the item’s value. No comparable panel is used in de-

98. *Id.* at 2703.
99. *Doherty v. Commissioner*, 63 T.C.M. (CCH) 2112, 2115 (1992), *aff’d*, 16 F.3d 338 (9th Cir. 1994). Note that *Doherty* address the value of artwork as it relates to a charitable contribution. While the statutory and regulatory provisions both utilize the hypothetical buyer/seller definition of fair market value, the parties’ motivations are reversed. While the estate or grantor will seek a reduction in value, and the resulting tax, the taxpayer making a contribution will seek to maximize value, and the resulting charitable deduction. *See* Treas. Reg. § 1.170A-1(c) (1995).
101. *Id*.
102. *Id.* § 20.3031-6(d).
104. *Id.* at 2-19.
termining stock or bond valuations. The panel valuation may then be used by the examining agent to challenge the taxpayer's reported value. Even if work is not analyzed by the Advisory Panel, examining agents are supported by regular IRS valuation engineers at both the national and regional level. The taxpayer still carries the burden of proof in valuing the included works of art, despite the resources available to the government.

In *Estate of Scull*, the Tax Court utilized a variety of techniques in determining the market value of a collection of artwork. In addition to applying the previously mentioned factors, the experts discussed the economic condition and forecast for the art market surrounding the valuation date, the prior ownership (provenance) of the works, and the reputation of the decedent as a collector.

The court in *Scull* placed a great deal of emphasis on auction sales of the artwork shortly after the valuation date. As with securities, actual sales near the valuation are considered the best evidence of value. For purposes of valuing artwork, auction prices constitute this best evidence of value. No evidence is more probative of fair market value than direct sales of the property in question. Auction results generally carry more weight than other estimates of value, such as appraisals or sales of comparable artwork. Using auction results, fair market value is the amount paid by the buyer, not the amount received by the seller. However, as the auction took place after the valuation date, allowance was to be made for any intervening price changes, in this case appreciation. Appreciation is highly relevant when the decedent was also the creator of the work because post-death appreciation is common. Accordingly, using auction results, the market value is the auction purchase price with an adjustment for any intervening changes. For example, the *Scull* court applied a 15% discount for appreciation. Finally, the IRS has taken the position that the amount paid by the buyer, including any buyer's premium, at the auction is the relevant determinant of market value, not the amount received by the seller.

If auction results are not available, expert appraisals are commonly used. The appraisals, as indicated above, are based on an evaluation of the attributes of the artwork, artist, transferor, and the economy. Attributes of the transferor include not only their reputation as a collector, but also the extent of their ownership interest. For example, the decedent in *Scull* possessed only a 65% undivided interest in the artwork. As a consequence the court reduced its determined value by 5% to account for the uncertainty of the decedent's

107. *Id.*
ownership claim. The general economy is relevant as a description of the art market, here, the market through which the hypothetical buyer and seller operate.

While individual works of art are unique, use of comparable sales is relevant, especially in conjunction with other methods such as appraisals. The sale of paintings, for example, by the same artist and from the same collection often provides corroborating evidence of value. The court in _Scull_ even referred to sales of similar items occurring twelve years prior to the valuation date.

2. Valuation of Other Assets

   a. Court Judgments & Claims

   One of the more interesting assets to value are litigation claims and court judgments. A final court judgment or settlement possesses a value generally equal to its amount, with an allowance for risk of uncollectability, plus accrued interest. However, a judgment that is currently on appeal, or otherwise not final, presents another problem. The judgment may be upheld in its full amount, modified on appeal, or even reversed. Even though the successful plaintiff may usually execute the judgment despite the appeal, it may still be altered or reversed. If reversed, the prior judgment will usually have no value unless the plaintiff has alternative means of recourse.

   Subsequent finality or settlement, even though it establishes value, is not conclusive evidence of value on the valuation date. In _Estate of Lennon_, the Tax Court addressed the value of a $7,750,000 court judgment that was on appeal on the valuation date. An agreed settlement for $5,250,000, made fourteen months after the valuation date, was not conclusive evidence of value, and the court rejected the government's use of the settlement amount. The court determined the market value of the judgment in the following manner. The $7,750,000 judgment was reduced for attorneys fees and court costs incurred in the litigation, to arrive at a net amount of $3,706,131. This amount was discounted by .53 to arrive at $1,750,000 as the fair market value of the judgment. The discount rate incorporated an appeal risk to account for the possibility of reversal or modification.

   Valuation of unlitigated claims is even more complicated than that of final judgments because the claims are subject to more contingencies. Unlike judgments, there is no quantitative basis for determining the value of the

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110. _Id._ at 329.
111. _Id._ at 330.
112. _Id._
claim. Rather, there is only the plaintiff’s allegation of damages and request for relief, accompanied by the defendant’s denial. The value depends on a number of factors, the most significant of which is the validity of the plaintiff’s claim and actual damages incurred. The biggest challenge in valuing unlitigated claims is attempting to value punitive damages. Unlike compensatory damages, punitives are not subject to any standard. They may be zero or possibly ten million. The amount of punitive damages depends on their availability under state law and the discretion of the jury and court. A recent case involving punitive damages is Estate of Davis,113 which involved the value of a decedent’s claim for securities churning. The decedent-plaintiff brought an action against Merrill Lynch seeking $122,000 in compensatory and $6 million in punitive damages. The suit was filed in August 1985 and the decedent died in November 1986. The valuation centered around the underlying litigation claim. The 1990 court judgment was for $100,000 compensatory and $2 million punitive damages and was subsequently settled for $2 million. In the Tax Court, the government asserted that the value was $2.1 million, while the taxpayer asserted a value of $62,000. The court rejected the estimates of both parties.

The Davis court divided the valuation issue into two components, the compensatory damages and the punitive damages. Compensatory damages were valued using a subtraction method. Starting with the amount of the claim for actual damages, the amount was discounted for costs of litigation, hazards of litigation, and time delay in receiving the funds. The court applied a 45% discount to represent litigation costs, including attorneys’ fees. Additionally, a 5% discount was used for the hazards of litigation and a 10% discount for the time delay. The final value was $46,000, derived from the actual damages incurred of $107,000.

The valuation of the punitive damage claim was a different matter. The Davis court recognized the lack of any ascertainable standard in computing such damages. However, the court did refer to the general purposes and uses of punitive damages. Punitive damages are completely discretionary with the jury and court. Their purpose is primarily to punish the defendant and to deter the defendant and others from wrongful culpable conduct. Factors often considered are the defendant’s wealth, plaintiff’s injury, and litigation expenses. The court also noted the possible unavailability of any punitive damages in Davis’ tort suit. To demonstrate the uncertainty of punitive damages, the court noted that the decedent sought $6 million in punitive damages, but received only $2 million (one third). However, the punitive damages awarded were twenty times the compensatory damages awarded by the jury. Despite the court’s discussion, it concluded that the value of the punitive damage

claim on the decedent’s date of death was $277,000 after subtracting litigation costs and made no mention of where the number came from.

b. Contingency Fees for Deceased Attorney

The previous section illustrated the issues inherent in valuing litigation claims. A related issue concerns the valuation of contingent legal fees of a deceased attorney. Contingent fees, like litigation claims, are difficult to value and are dependent upon the uncertainty of underlying lawsuits. Contingent legal fees are usually specified as a percentage of the client’s recovery. As a result, if there is no recovery, there are no legal fees. However, just as litigation claims are includable in the estate of the deceased plaintiff, contingent legal fees are includable in the gross estate of the deceased attorney. The fact that the legal fees are contingent upon recovery does not, as a matter of law, preclude its inclusion in the gross estate. However, the contingent nature of the right must bear on the factual question of valuation.

The Tax Court addressed this issue in Estate of Curry, in which it determined the value of a deceased attorney’s right to receive contingent legal fees in claims before the Indian Claims Commission. The decedent had represented Indian tribes before the Indian Claims Commission and was to receive a percentage of the recovery. Before his death, the decedent assigned his right to recovery to another attorney, retaining a percentage of the recoverable fees. Upon the decedent’s death, a number of the cases were still unresolved, though some were disposed soon thereafter. The court stated that amounts actually received after death were not conclusive of the value at the decedent’s date of death. The court did acknowledge that the determination of value was incapable of exact enumeration. The valuation decision was determined through reliance on numerous factors. Included among these factors were the factual and legal nature of the underlying claims, the stage of litigation at the date of death, quality of representation (in terms of past successes), and the inherent delays in litigation. Based on these factors, the court valued the estate’s right to contingent legal fees. The total valuation determination was reached as an aggregate of determinations of underlying cases, as of the date decedent’s death.

115. Estate of Curry, 74 T.C. at 546.
116. Id.
117. Id. at 551.
118. Id.
c. Valuation of One's Name

A recent decision of a United States District Court in Virginia addressed the valuation of a deceased author's name.119 This was an issue of first impression and is quite unique in its factual background. The case involved the value of the name V.C. Andrews on the date of her death. Andrews was a successful author whose books often appeared on best seller lists. Following her death, the publisher and the estate agreed to continue writing and publishing books under the decedent's name, using a ghostwriter. Under the agreement, the publisher agreed to pay advances and royalties to the estate as compensation for the use of decedent's name. The publisher considered the V.C. Andrews name as a source of significant revenue and was willing to pay for its use. According to the IRS, the estate possessed a valuable asset in the form of the right to use the decedent's name. The IRS asserted that this right, the right to use the decedent's name, had a value that had to be included in the gross estate. A dispute arose over the proper value of this asset, namely the fair market value of a famous author's name.

In resolving the valuation issue, the District Court analyzed the situation relying on the hypothetical buyer-seller standard. The court determined what a buyer and seller would know and consider relevant in determining a sales price on the date of the decedent's death. The rights in question were defined as the right to use the decedent's name and persona, publish and sell ghost-written books using the decedent's name, and the underlying copyrights for the books.

The decedent had signed, though not executed, a publishing contract before her death. The contract offered $3 million for two ghost written books and was subsequently executed after her death. Additional contracts were executed for additional books. The first book was published, under the decedent's name, and was a commercial success. Subsequent books were published with similar success. It was not until the fifth book, over three years after decedent's death, that her death was confirmed to her audience. Based on this success, the IRS asserted a value of over $1.2 million, while the estate asserted a significantly lower number.

According to the District Court, the following facts would be known to a hypothetical buyer and seller and form the basis for their sales price. Note that only facts reasonably known on the valuation date are relevant. These facts included the existence of the unexecuted publishing contract (which was executed after the decedent's death) the possibility of using a ghostwriter to write additional books, and the opportunity for significant financial gain, as the contract called for $3 million for two books. However, the parties would

also realize the risk of not locating a suitable ghostwriter, the potential commercial failure of a ghostwritten novel, the negative impact such a failure would have on sales of previously written work, and the availability of alternative investments.

Based on these facts, the court accorded great weight to the first publishing contract and the amount paid for the first ghostwritten novel. However, the court regarded the later publishing contracts as unforeseen events occurring after the valuation date. These later contracts occurred as a result of the post-death success of the ghostwritten novels. The subsequent success of the later novels was not reasonably foreseeable. Indeed, a significant risk of failure presented itself on the valuation date. Using the first contract as a starting point, the court used the $1.5 million advance for the first ghostwritten book as a starting point. Based on this starting point, the court applied a 33% discount to account for the risk of failure. The final determination was approximately $700,000. As a result, the District Court concluded that the date-of-death value of the decedent’s name, in the hands of the estate, was $700,000.

D. Valuation Discounts and Premiums

For both corporations and partnerships, business valuation entails more than computing the fair market value followed by determining a proportionate share. The valuation methods elaborated above focus on discerning the value of the total business. The value of an interest in the business is usually determined as a percentage of the whole. For example, a 45% interest in a business valued at $1,000,000 would amount to $450,000. However, the value of the interest in question is not always equal to its share of the whole. It is in these cases that the issues of discounts or premiums arise.

1. Discount for Lack of Marketability

Discounts for lack of marketability are those most commonly sought by taxpayers and are frequently granted by the courts. The discount arises out of the recognition that closely held stock and partnership interests are less attractive to investors and have fewer potential purchasers than publicly traded stock. It is assumed that a rational investor would prefer a liquid investment to one that is nonliquid. However, the degree of preference is uncertain. Note that a comparable discount is allowed for securities that are subject to resale restrictions under federal securities laws. A liquid investment is preferred by investors because it provides a quick exit in the face of excessive losses. Accordingly, some form of discount is usually allowed in valuing


Confusion often arises between the discount for lack of marketability and the minority discount discussed below. It is essential to realize the lack of marketability or "illiquidity" discount often applies where a minority discount would not. An illiquidity discount is applicable when valuing both controlling and minority ownership interests. The discount has even been applied to a 100 percent ownership interest in a closely held corporation.\footnote{123}{Estate of Bennett, 65 T.C.M. at 1825-26.}

In \textit{Estate of Bennett},\footnote{124}{65 T.C.M. (CCH) 1816 (1993).} the Tax Court held that in determining the illiquidity discount, the corporate form may not be ignored. Even though the taxpayer held all the stock of the corporation, the stock was still restricted in its transferability and the underlying corporate assets were themselves nonliquid. The minority and illiquidity discounts serve different purposes and functions. While they may overlap in cases, they are not synonymous.

As stated earlier, the illiquidity discount is also applied to partnership interests.\footnote{125}{Moore, 62 T.C.M. at 1131-32.} In \textit{Bennett}, there was no established market for the partnership interests. Indeed, most partnership interests are non-transferable under either state law or the underlying partnership agreement. An exception exists for master limited partnerships, though they are few in number. The essence of their discount is that a nonliquid interest is worth less than the market value of its claim on the business, primarily because the owner has no easy way of exchanging it.

Despite the common use of the discount, there are cases in which it is disallowed. The primary reason is the failure of the taxpayer to establish a satisfactory discount amount. As usual, the burden is upon the taxpayer to prove the necessity and amount of the discount. For example, in \textit{Estate of Bell},\footnote{126}{Id. at 1825-26.} the Tax Court acknowledged that a lack of marketability discount would be proper, but did not allow one as the taxpayer did not satisfactorily establish the discount amount.\footnote{127}{Id. According to the court, the taxpayer must establish both the value to be discounted and the amount of the discount by a preponderance of the evidence.\footnote{128}{Id.}}
While still the responsibility of the taxpayer, the amount of the discount is inherently subjective. One source of the discount amount, applicable when valuing a controlling interest, is the total cost of registering the securities with the Securities and Exchange Commission. The costs of registration are thus the costs of converting the nonliquid securities into liquid ones. This method would not be applicable when valuing minority interests, as holders of such interests are incapable of compelling registration. Additionally, partnership interests are generally nontransferable.

There are other computation techniques and criteria that are employed in determining an illiquidity discount. Factors to consider include the costs and amount realizable on a private placement or secondary offering. Additionally, the opportunity cost of losing access to the invested funds is highly relevant. Other relevant factors are the discounts applied to comparable transactions involving sales of comparable closely held businesses. One court has called for consideration of the firm’s dividend-paying history and capacity. Despite considerable case law, there is still no established formula to compute the discount amount.

2. Minority Discount

Another common discount is that available for minority interests in businesses. Like the illiquidity discount, this discount is based upon the practical realities of the marketplace. It makes an allowance for the fact that a minority interest in a closely held corporation or partnership does not possess voting control and is often subject to the controlling ownership interests. As a result, a minority interest is considered to be worth less than its pro rata share of the underlying assets. The minority discount is recognized because the minority shareholder lacks the ability to control dividend payments, liquidations or the effectuation of corporate policy.

While the minority discount is separate from the illiquidity discount, neither applies to publicly traded stock. Minority discounts are already incorporated in the trading prices of public stock. Thus, when one purchases shares

131. Id.
132. Estate of Jung v. Commissioner, 101 T.C. 412, 435-36 (1993). The experts in the above cases utilized comparable private placements, as well as various institutional studies, such one by the SEC, on transactions involving restricted stock.
134. Smith, supra note 1, at § 52-10. See also Estate of Wildman v. Commissioner, 58 T.C.M. (CCH) 1006, 1010 (1989) (minority interest discount applicable in valuing real estate).
135. Estate of Titus, 57 T.C.M. at 1456.
on an exchange, he is buying and paying for a minority interest. Following this rationale, the IRS has contended that use of comparable sales of publicly traded securities in determining value also incorporates a minority discount. However, courts have been reluctant to agree. While the comparable P/E ratios and other financial factors derived from publicly listed stock incorporate a minority discount, a minority position in a closely held corporation is worth less than that in a publicly owned firm. Further, the IRS argument that the discount is nullified by the fiduciary duty owed by the majority owners to the minority has met little success in the courts.

Like other discounts, the amount of the minority discount must be illustrated and supported by the taxpayer. The courts have allowed discounts as high as 35 percent. A study of minority discounts has revealed that courts are permitting increasingly larger allowances. However, neither the courts nor the IRS have provided much guidance as to how the discount is to be computed. Traditional factors such as sales of comparable closely held minority interests have been used.

As mentioned, there is considerable confusion over differences between the minority discount and the lack of marketability discount. The minority discount serves as compensation for lack of control over the investment, while the illiquidity discount serves as compensation for limitations upon free exit. While different, the two occasionally overlap. For example, one attribute of minority ownership in a closely held corporation or partnership is the inability to force a liquidation or other avenue of escape. This characteristic is an element of illiquidity. Despite the overlap, however, the two discounts are conceptually distinct. While controlling shares in a nonpublic corporation do not qualify for a minority discount, they may still suffer from lack of marketability due to the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock. Moreover, to reinforce the distinction, the

136. Id.
137. Id.
138. Id.
139. See Estate of Piper v. Commissioner, 72 T.C. at 1062.
142. Smith, supra note 1, at § 52-10.
144. Moore, 62 T.C.M. at 1133.
145. Id.
two discounts are to be applied separately. Despite this conceptual distinc-
tion, however, a single combined discount is often used.\textsuperscript{147}

A final issue relevant to both minority discounts and control premiums,
the latter of which is discussed below, is family attribution. This issue arises
when the interest of the transferor is that of a minority owner, but a majority
of the ownership is in the hands of the transferor’s family. Attribution would
include the family’s ownership along with the interest in question, often con-
verting a minority position into a controlling position. The position of the
government has been to oppose a minority discount when family attribution
would create a controlling interest. Indeed, the government has even pushed
for a control premium in certain cases.\textsuperscript{148}

However, the Fifth and Ninth Circuits as well as the Tax Court have re-
jected application of family attribution in the context of transfer taxation.\textsuperscript{149}
Two factors were raised in support of the anti-attribution rule. The first is the
long line of cases holding that family attribution does not apply to the trans-
fer tax area.\textsuperscript{150} The second deals with the hypothetical buyer-seller standard.
According to the courts, the use of family attribution would identify the seller
with the decedent and the decedent’s family. The hypothetical seller is an ob-
jective seller that should not be identified with a specific person or group, such
as a family. Application of the attribution doctrine would place too much
weight on particular parties and violate the objectivity principle.\textsuperscript{151} However,
the IRS may still attempt to assert the existence of a control premium through
use of family attribution.

3. Control Premium

The opposite of the minority discount is the control premium. While the
minority discount compensates for decreased control, the control premium
charges the owner of the interest for increased control. The premium is based
on the recognition that a controlling interest has more power than a minority
interest to affect changes in corporate structure and influence corporate poli-
cies. Thus, the interest is worth more than its pro rata share of the total

\textsuperscript{147} Estate of Titus v. Commissioner, 57 T.C.M. (CCH) 1449, 1456 (1989).
\textsuperscript{148} Rev. Rul. 81-253, 1981-2 C.B. 187. One case relied upon by the government is
\textsuperscript{149} Estate of Bright v. Commissioner, 658 F.2d 999 (5th Cir. 1981); Propstra v. United
States, 680 F.2d 1248 (9th Cir. 1982); Estate of Lee v. Commissioner, 69 T.C. 860 (1978),
\textsuperscript{150} See Estate of Piper v. Commissioner, 72 T.C.M. (CCH) 1062 (1979); Estate of Zaiger
v. Commissioner, 64 T.C. 927 (1975); Richardson v. Commissioner, 2 T.C.M. (CCH) 1039
(1943), aff'd, 151 F.2d 102 (2d Cir. 1945); Whitemore v. Fitzpatrick, 127 F.Supp. 710 (D.
Conn. 1954).
\textsuperscript{151} Estate of Andrews v. Commissioner, 79 T.C. at 954-55.
A holder of a controlling interest often possesses control over the entire firm, including the portion represented by a minority interest. For example, a 75 percent owner would control 100 percent of the corporation. As a result, the 75 percent interest is worth more than 75 percent of the total corporate value. In effect, the premium is the corollary to the minority discount. A 20 percent minority discount often means a 20 percent control premium for a controlling owner, if there is one. However, unlike the minority discount, the control premium is applicable to publicly listed stock, since such stock is usually valued as a minority interest.

The value of the control premium may come from a number of sources. Generally, the converse of the minority discount factors are used. One court used sales of minority interests to compute a control premium. For example, if a 30 percent shareholder receives a 10 percent minority discount, the 70 percent shareholder should receive a 10 percent control premium. Other sources of information in determining a control premium are the premiums paid through corporate tender offers for controlling interests. Additional factors are premiums paid for control of comparable corporations, statistical information on average control premiums paid, and court decisions on the subject. The control premium is generally expressed as a percentage by which the amount paid for a controlling block of stock exceeds the amount which would have otherwise been paid for the shares if sold as minority interests. Examples of control premium amounts include Estate of Feldmar (15%), Estate of Oman (20%), and Estate of Salsbury (38%). Interestingly, one taxpayer actually benefitted from a control premium when it increased the value of his marital deduction. The control premium, along with the other allowable discounts, raises the notion that the sum of the parts does not always equal the whole.

154. Smith, supra note 1, at § 52-15.
156. Id.
157. See supra note 19, at
158. See supra note 42, at
159. See supra note 151, at 1451.
160. Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1589-90 (1987). The value of a marital deduction, consisting of a 51% interest in a closely held corporation, was entitled to be increased by a control premium. The discrepancy results from differing definitions of value. The gross estate is valued from the viewpoint of the decedent, while the marital deduction is valued from the viewpoint of the recipient spouse.
4. Blockage Discount

Another commonly used discount is the blockage discount. The discount applies when valuing large blocks of stock. When sold as a group, the individual shares within the block typically sell at a reduced market price. The blockage discount accounts for the impact a sale of an abnormally large number of shares would have on market price and is in essence a discount for flooding the market. The discount encompasses a situation where a block of stock (or other asset) is so large in relation to the total sales volume that it could not be liquidated in a reasonable time without depressing the market price.

The concept of blockage is essentially one of timing. A discount may be allowed where a large quantity of any type of commodity is offered on the market at any one time and would substantially depress its value. The amount of the discount is determined, in part, on an estimate of the time it would take to sell the entire quantity in smaller lots. Some factors considered in determining the discount include the opportunity costs of holding the inventory until sale, the carrying costs, and the expected time period to complete all sales. The relative size of the commodity inventory is also a factor. For stocks, consideration is made of the size of the block, market trends, industry trends, growth potential and earning capacity of the shares, and the possibility of limited liquidity of the shares.

Blockage discounts are not uncommon in stock valuation, especially large sales of publicly traded stock. For example, the block of stock in Friedberg was equivalent to 148 times the weekly trading volume and was valued at a significant discount of thirty percent. In determining the discount, the court considered comparable sales of large blocks of stock of comparable corporations, usually through secondary offerings. Also, the court estimated the selling price of the block of stock through a private placement, secondary offering, corporate redemption, and even an SEC Rule 144 offering. The court stated that what a buyer would pay should be emphasized, and not what the seller would receive. This treatment is similar to that accorded to auction results.

162. Smith, supra note 1, at § 52-12.
165. Id. at 3081-89, 3081-84.
166. Id. at 3081-88.
167. Id. at 3081-87.
Blockage discounts are not applied solely to stocks. Rather, they are used in the valuation of land and many other commodities. The Tax Court applied a blockage discount in *Estate of O'Keeffe.* In that case, the court considered the value of each individual work of art and proceeded to compute a total combined value, taking into consideration the depressing effect such a large collection would have on the market price. The court realized that, as a result of blockage, the total combined value of the artworks would be less than the sum of their individual market values. The court divided the collection into two groups based on ease of sale. The most salable group received a 25% discount, while the other received a 75% discount.

Like the other discounts and premiums, the blockage discount serves as an adjustment to the fair market value determined by any of the previously stated methods. These discounts and premiums allow for the characteristics of the particular asset to enter into the determination of value. They are all based on the notion that the sum of the parts does not always equal the whole.

5. Other Discounts

There are a number of other discounts that occasionally arise in asset valuation. As with the more common discounts, these provide a fair market value adjustment to reflect specific facts or circumstances of the underlying assets. While there are a great number of these less common discounts, those encountered most often are the following: a key man discount (to compensate for the reduction in value resulting from the loss of a key member of management, usually the decedent), a discount for the risk of pending litigation, and even a discount for the burdens of joint ownership. Finally, there is also a discount available for diminished voting rights. There are a number of other applicable discounts, but the taxpayer must prove both their necessity and amount by a preponderance of the evidence.

169. *Estate of O'Keeffe v. Commissioner,* 63 T.C.M. (CCH) at 2704.
170. *Id.* at 2702.
171. *Id.* at 2703.
172. *Id.* at 2707.
IV. CONCLUSION

Valuation is the heart of the transfer tax system. The value of the transferred property compromises the tax base for the estate tax, gift tax, and generation-skipping transfer tax. However, computation of value is inherently subjective and is more of an art than a science. Even stock traded on listed exchanges possesses a subjective element regarding the application of premiums or transfer restrictions. As a result of their importance and the subjectivity of derivation, valuation disputes constitute a large portion of taxpayer litigation.

Despite its importance, there is no single method of computing value. Generally, the taxpayer must incur the expense of expert appraisers and analysts. While there are a number of valuation methods, such as capitalization of earnings, discounted cash flows, and net asset value, there is no single accepted methodology. However, certain factors stand out in importance, such as comparable sales, earning capacity, general economic and industry trends, and the value of the underlying assets.

While the bulk of valuation litigation concerns business interests, such as shares of stock, other forms of assets are subject to valuation disputes. Real estate, artwork, contingency claims, even one's own name are subject to inclusion in the gross estate and resulting valuation. While quantitative methods are available, the determination of fair market value still requires professional judgment. Works of art, for example, are susceptible to varying determinations of fair market value and are likely to result in litigation.

Even after computing a value, a number of discounts and premiums are still available for application. The primary ones are lack of marketability, minority and blockage discounts, and a premium for control. Additionally, the use of valid restrictive sales agreements often eliminates the need for complicated valuation computations.

All in all, valuation is an incredibly subjective art form with only very general authoritative guidelines. As the Tax Court stated, "Valuation of property is often capable of resolution only through Solomon-like pronouncements."177

177. Id. at 1579.