

Fundamentals of Fair Market Value

All business valuations are context-sensitive in that their outcomes depend on what is being valued, why it is being valued, and for whom it is being valued. The choice of an approach or approaches to value and the specific methodology employed should be based on the type and characteristics of the property being valued, any applicable legal requirements, and sensible and rigorous financial and economic analysis. To help define the valuation assignment and choose the appropriate approach(es) to value and the specific methodologies there under, the business valuation profession has developed a list of basic elements necessary thereto.

One of those elements is the standard of value being employed in the assignment. Since the word "value" can mean different things to different people, it is essential that the term be defined if the conclusion of value developed in the report is to have any meaning. The standard of value in a report tells the reader what definition of value is being arrived at in the particular assignment. The standard of value is different from the premise of value, which informs the reader of what assumptions have been made about the situation of the hypothetical transaction environment, e.g., going-concern or liquidation.

The critical information set forth in the standard of value includes whom the buyer and seller will be-it specifies the parties to the transaction. Put another way, the standard of value answers the questions, "value to whom?" and "under what circumstances?" In addition, the standard of value will dictate what valuation methodologies are appropriate and what other factors ought to be considered. One of the most prevalent standards of value is fair market value.

Fair Market Value

The concept first appeared in the Revenue Act of 1918, which provided that "when property is exchanged for other property the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value."

Advisory Tax Board Recommendation 57 was issued by the Bureau of Internal Revenue in 1919 to define fair market value. The recommendation stated, "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price. The adjective "fair" emphasizes the idea of fairness inherent in the conception of market value, and excludes any possibility of a construction of the words "market value" with reference to a market which, or to circumstances of sale under which, for any reason a fair price could not be obtained.

The opening sentence has been carried forward in some fashion to Revenue Ruling 59-60, where it is incorporated into that document's definition of fair market value. The second sentence, which requires a "public of possible buyers" to be in place for buyers and sellers to transact at fair market value did not make the cut when Revenue Ruling 59-60 was published. And the last sentence is merely a tautology or circular reference that was dropped for good reason.

Revenue Ruling 59-60, in Section 2.02, defines fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Elsewhere in Revenue Ruling 60 the fair market value price is paid in terms of money or money's worth, making it a cash equivalent price as was originally mentioned in the Revenue Act of 1918. In addition, in 1929, the Board of Tax Appeals, the predecessor to the current Tax Court, developed the idea that the buyer and seller are hypothetical characters, and accordingly, this notion produces a value-in-exchange concept that is without regard to the specific current owner or any specific buyer.

Standards of value put the valuation report reader on notice as to the type of value being used in that valuation engagement. Common standards of value are fair market value, fair value, investment or synergistic value, ad valorem value for property tax purposes, etc. Since each of these values is defined in opposition to fair market value, let's see how that standard of value is applied.

Fair market value is a concept that can be used heuristically to determine if a particular conclusion of value has met the definitional standard. For example, if the seller is motivated to sell—because of business distress, the traded value will not be at fair market value because the seller is an unwilling seller in that he or she is under some compulsion and "needs" to sell rather than "wants" to sell. This type of seller is often defined as "motivated." Another example is when the price offered by a competitor, who is attempting to gain market share, or perhaps trying to enter a new territory, contains a premium. As the business is worth more to this particular buyer because of the synergies expected to be realized after the purchase, then once more we do not have a transaction at fair market value. We have instead investment value, the value to a specific buyer, rather than a hypothetical buyer.

Very often we hear sellers tell buyers, "my price, your terms." This often results in creative financing where the seller holds paper with a below-market rate of interest. Since this seller financing creates a price that is not cash equivalent, the transaction fails the fair market value test. When the buyer is not informed by the seller that a new competitor will be moving into the neighborhood nine months after the transaction closes, the price paid will not be at fair market value, as one of the parties did not have reasonable knowledge about a very relevant fact. Tied closely to the idea of reasonable knowledge, is the concept of what is "known or knowable" as of the valuation date, also known as the subsequent events doctrine. Since buyers and seller do not have crystal balls and cannot be cognizant of events that will transpire after they transact, so too are business valuers restricted to what is known or knowable as of the date of valuation. To make use of information that comes to light after the date of valuation is to violate the fair market value standard.

For small businesses, where a financing rule of thumb is one-third each from the buyer, the bank, and the seller, those sellers who are unwilling to carry their third of the deal will not obtain a price equivalent to what the business is worth under the fair market value standard as they are not truly able to sell. Therefore, those sellers who are willing to sell but unwilling to finance are willing but not able sellers.

These examples offer practical applications of what fair market value means when the whole business is being sold. However, when 50% or less of a company's stock is being offered for sale, other concepts must be considered before we can arrive at fair market value. Revenue Ruling 59-60 states: "Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock" However, it does not go on to discuss what impact this has on fair market value or how to measure that impact. Further, since minority shareholders cannot force the sale of the company's stock or its assets and are dependent on the majority shareholder for the size and timing of their dividends or distributions and ultimately when the whole business will be sold so they can reap their capital gains, they suffer from what is called a marketability discount. This discount is taken from the company's 100% control value and, depending upon principally the amount of dividends and distributions expected to be received and the date of eventual sale of the whole company, can run as high as 80%. This discount from control value must be taken into account before minority shares can be considered to be at fair market value.

This article has attempted to put the idea of fair market value in some historical context and demonstrate how the ideas contained in its definition permeate the valuation process by impacting choices of approach, methodology, and discounts and premiums, among other items.

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