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The Tax Tail Can't Wag the Valuation Dog: Five Key FMV Rules

Chuck Hodges, Simon Hansen, Anthony DeRiso, and Tyler Jackson*
Jones Day

By applying five valuation principles that are frequently ignored or misapplied by the tax community, the IRS and taxpayers could resolve more valuation disputes amicably and without court involvement, say Jones Day practitioners.

As many as 250 sections of the Internal Revenue Code require fair market value estimates to assess tax liability (*Estate of Auker v. Commissioner*, T.C. Memo. 1998-185). In turn, millions of tax returns are filed with the IRS each year that report an event involving a valuation issue (*Id.*). This has placed the tax community, including the US Tax Court, in the challenging position of dealing with fact-intensive valuation-related disputes, especially, recently, with respect to charitable contributions of conservation restrictions under §170 (*See, e.g.*, *Green Valley Investors, LLC v. Commissioner*, T.C. Memo. 2025-15; *J.L. Minerals, LLC v. Commissioner*, T.C. Memo. 2024-93; *Seabrook Property, LLC v. Commissioner*, T.C. Memo. 2025-6; *Jackson Crossroads, LLC v. Commissioner*, T.C. Memo. 2024-111). Since tax practitioners do not conduct appraisals professionally (although some mistakenly believe they could), skepticism arises when an appraiser's valuation appears inconsistent with actual sales of similar assets or other perceived "real world" transactions or market activity.

This article addresses that skepticism and highlights five principles tax practitioners should account for in valuation-related disputes:

1. The tax law's definition of fair market value includes a hypothetical willing buyer and willing seller, both having knowledge of all relevant facts because *both are market participants*—which is rarely the case in actual sales;
2. A sale *must occur* to properly measure the taxable event, and such sale must be fair to both market participants—that is, one must consider the range of prices a buyer would reasonably pay (the ceiling in the range of value) *and* that a seller would reasonably accept (the floor in the range of value);
3. The hypothetical buyer and seller will take into account their respective bargaining positions;
4. Inherently, the *principle* of substitution is not a valuation method, but instead a maxim that supports, but does not supplant, all three valuation methods; and
5. The value produced by applying the discounted cash flow income method is rarely a "business valuation" as evidenced by the fact, for example, that this value is reduced by the cost of newly-purchased equipment and ignores most intangible rights such as workforce.

*Chuck Hodges, Esq. and Simon Hansen, Esq. are partners at Jones Day. Anthony DeRiso, Esq., and Tyler Jackson, Esq. are associates.

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This article attempts to explain inherent *aspects* of these principles for tax professionals and is not meant to be an exhaustive discussion for the appraisal community who already embrace these concepts. And while these principles apply in many, if not most, valuation scenarios, this article examines fair market value from the standpoint of real property rights, including the valuation of conservation restrictions under §170.

Expanded Definition of Fair Market Value

Fair market value has generally been defined as the price that a piece of property would bring if offered by a willing seller to a willing buyer, neither being obligated to buy or sell (*Elmhurst Cemetery Co. v. Commissioner*, 300 U.S. 37, 39 (1937)), taking into consideration all uses to which the property was adapted and might in reason be applied (*Grand River Dam Authority v. Grand-Hydro*, 335 U.S. 359, 367 (1948)). This definition contemplates a hypothetical transaction in which each party is fully informed of the relevant facts (*Boltar, L.L.C. v. Commissioner*, 136 T.C. 326, 331 (2011)). The phrase "relevant facts" presumes a certain level of ability by the parties to actually make use of those facts. Thus, the buyer and seller are assumed to be active participants in the markets in which the property trades.

To properly determine fair market value for tax purposes as described above, the following five valuation principles must be properly applied.

Principle 1: Identifying the Property's Markets

A property's value is affected by the markets within which it trades. A "market" can be understood as the extent of economic demand for particular goods and services ("Market," Black's Law Dictionary (12th ed. 2024)). A product may simultaneously fall into one of several markets. For example, a particular piece of real property may be utilized for farmland or for its subsurface mineral resources—uses for which separate markets exist—and thus the property may attract interest from buyers in both markets. The price at which the property trades in either market, however, may vary as, for instance, a farmer in need of a pasture may be inclined to offer less for it than a quarry operator. That price difference will be based (at least in part) on the profitability of each particular use.

To determine the specific markets within which a piece of real property will sell, it is incumbent to identify all of the particular uses for which that piece of property is suitable (*Grand River Dam Authority v. Grand-Hydro*, 335 U.S. 359, 367 (1948)). In practice, appraisers and others identify the range of particular markets in which real property may sell by reference to the physically possible and legally permissible uses to which the property can be put. Real property, for example, that is unable to yield crops due to its rocky terrain will not trade within the market for farmland and, accordingly, data on the "going rate" for farmland will not be a useful gauge of its worth. That same piece of land, however, if susceptible to drilling, may attract interest in the market for the extraction and sale of minerals.

The most probable market within which a piece of property will sell is determined by looking at which physically possible and legally permissible use of the property will be its most profitable, or, in appraiser parlance, which use will amount to its "highest and best" or maximally productive use (Appraisal Institute, *The Appraisal of Real Estate* 52 (15th ed. 2020)). A determination of the most probable market within which the property will sell—and, in turn, the relevant market for identifying its fair market value—therefore requires an actual analysis and ordering of the profitability of each proposed use of the property (e.g., comparing the profit potential of the property's use as a farm to its use as a quarry). If one use of a property (say, farming) is less profitable—not as financially feasible—than another (say, mining), then, all things equal, the property should sell in the market for property which can be put to that more profitable use.

Two points about a property's "highest and best use" are sometimes overlooked by the tax community. First, the "uses" to which real property can be put should not be confused with the motivations of its owners for holding it. For example, conservation and preservation are not uses of land. Rather, they are the motivations for acquiring property. To determine fair market value, one must look past these motivations and toward the actual uses to which property can be put (as above). Similarly, land that is acquired primarily for future use, with or without an interim use, may be regarded as a speculative investment, and not an actual use. As before, the term speculation describes a motivation rather than a use (*The Appraisal of Real Estate* 311 (15th ed. 2020)). In these instances, the valuation of the property still depends on

the highest and best use to which it can be put, with consideration given, however, to the fact that demand for a reasonably foreseeable future use (with no specific timeline) of the property may result in that future use (with or without any interim use) being its highest and best. In other words, if a buyer's reasonable speculation is to purchase land with minerals based on foreseeable demand for the minerals, then the extraction and sale of the minerals can, and may be, considered the highest and best use *today*. But, buy and hold is not.

Second, appraisal authorities do not presume that the "current use" of a property is its highest and best, and neither should tax professionals. That is, in the appraisal community, an analysis to determine which use of a property is maximally productive requires just that—a profitability analysis. Although cumbersome, tax valuations must follow suit in requiring parties advancing that the property's current use is its highest and best to demonstrate, not presume, its profit potential. The appraisal community has no "default" use where the financial feasibility prong can be ignored, and neither should the tax community.

Principle 2: Hypothetical Buyer, Seller are Participants in Each of the Markets Within Which the Property Could Trade

The surplusage canon demands that every word in a statute be given effect (*See generally* A. Scalia & B. Garner, Reading Law: The Interpretation of Legal Texts 174-179 (2012)). Applying a similar rule of thumb to the definition of "fair market value" would suggest that consideration must be given to the word "fair," and how that impacts the market value of a piece of property.

Courts give effect to the word "fair" when addressing valuation questions by presuming a market transaction in which both the buyer and seller of the relevant property are "hypothetical persons," (*Chapman Glen Ltd. v. Commissioner*, 140 T.C. 294, 325 (2013)) with "neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." (*e.g.*, Treas. Reg. §1.170A-1(c)(2)). To determine the attributes of these hypothetical persons, and for the transaction to provide a full and "fair" representation of the property's value, it must also be assumed that the parties are: (1) *foremost*, participants in the market within which the property could sell (as determined by its highest and best use, above); and (2) *equally capable* of putting the property to that particular use, if desired. These assumptions are necessary to ensure that the full value of the underlying property is captured through the hypothetical transaction, as only market participants will understand, appreciate, and be able to exploit the drivers of that particular property's value. The tax community frequently excludes "market participants" from the definition of fair market value and assumes the hypothetical seller is the actual seller in the transaction at issue, with in many instances limited knowledge and skills.

Take for example, real property that could be put to use as either farmland (a less valuable use in this hypothetical) or commercial real estate (a more valuable use) and the seller is a farmer and the buyer a developer. The farmer may lack the experience and capital, or otherwise, to exploit that potential commercial use. Thus the farmer—with limited development knowledge and unable to commercially develop the property himself—may accept a price that is indicative of the property's continued use as a farm, or a reduced value because of his inability to commercially develop the property.

In this hypothetical, the price at which the property changed hands does not represent a "fair" approximation of the value of the property. Here, the buyer was able to capture and enjoy additional consumer surplus (the difference between what the buyer was willing to pay—commercial real estate prices—and what he or she in fact paid) by purchasing the property at farmland prices. In this scenario, the true, full, and "fair," value of the property would instead be the sum of the price paid by the purchaser *plus* (at least some of) the consumer surplus enjoyed as a result of entering into the transaction.

If, under the same set of facts, each party was *equally* capable of developing the property into commercial real estate, the seller would be less willing to accept farmland prices for the property when he or she, in the alternative, could develop the property and directly capture those rents. In this situation, with an equally capable buyer and seller, the price at which the property would change hands might represent the net present value of the future net cash flows the (equally capable) buyer or seller could earn from putting it to its highest and best use. At this price (which could be stated as a range of value), there would be neither significant

consumer nor producer surplus (if any) to be enjoyed (gained) by either party as, if the transaction was priced less, it would make more economic sense for the farmer to walk away from the sale and develop the property him or herself, and vice versa (*See Chapman Glen*, 140 T.C. at 325 ("The views of both hypothetical persons are taken into account, and focusing too much on the view of one of these persons, to the neglect of the view of the other, is contrary to a determination of fair market value."). Accordingly, in a negotiation between equally capable market participants, this is the only price *both* parties would economically be willing to accept for purposes of determining "fair" market value.

Principle 3: Hypothetical Buyer, Seller Take Into Account Their Respective Bargaining Positions

Within the definition of fair market value is a negotiation between equals. Contemplated is a transaction in which either party can walk away from an agreement that includes any terms that they do not like.

Parties determine the price at which they will walk away from a negotiation by reference to what is commonly referred to as their "BATNA"—or their "best alternative to a negotiated agreement," a term coined by Harvard Professors Roger Fisher and William Ury in their seminal book on negotiating, "Getting to Yes," which is taught in business schools across the nation (R. Fisher & W. Ury, *Getting To Yes: Negotiating Agreement Without Giving In* (2011)).

A party's BATNA is measured by reference to the best alternative option available to the party if the negotiation falls through (i.e., its opportunity cost) (*See Sunstrand v. Commissioner*, 96 T.C. 226, 324 n.46 (1991) ("'Opportunity Cost' is the economist's term for the 'amount that the decisionmaker fo[r]goes by choosing to do A rather than B."')). The more alternative options available to a party to a negotiation, the stronger its bargaining position becomes, which, in turn, improves the party's ability to extract more favorable terms from the other side. For a buyer, this means looking at the range of returns that any available alternative investments would generate while, for a seller, this means looking at the most profitable use to which the property could be put absent a sale, and/or at how much someone else is offering.

Because each party's BATNA represents its respective walk away point, the seller's BATNA represents the "floor," or lowest price, at which the property will trade hands, while the buyer's BATNA represents the "ceiling," or highest price. The gap between the seller's BATNA and the buyer's BATNA thus represents the range of prices within which an agreement can be reached. Where precisely a price falls within this range depends on other factors, such as the presence of competitors (*See, e.g., Van Zelst v. Commissioner*, 100 F.3d 1259, 1262 (7th Cir. 1996) (noting that an owner of a parcel containing a vein of ore with a present value of $650,000 would not sell it for anything less)). The seller's floor price is often ignored in tax valuations, as demonstrated by the frequency in which the argument is made by the IRSin charitable contribution cases and taxpayers in estate tax cases: "no buyer would ever pay that amount…". This flawed argument ignores the fundamental premise that the seller is a market participant, could use/develop the property him or herself, and is thus under no compulsion to sell the property. Therefore, the sales price must also be fair to the seller based on what he or she is giving up.

Over the years, three methods of valuation have developed that help parties measure their respective BATNA: the sales comparison approach, the income approach, and the cost (replacement) approach.

The sales comparison approach looks for evidence of arm's length sales of comparable properties. In theory, this alerts the buyer or seller to the price for which other similarly situated properties are selling. To be comparable, however, a proffered sale of, for example, real property must not only feature similar physical characteristics (e.g., acreage, road frontage, topography, etc.), but also must have been entered into at arm's length between similarly-situated market participants. As in the example above, a sale of commercial property by a farmer who is unaware of, and unable to, commercially develop the land may not be indicative of the full and "fair" value of that property where the BATNA of that farmer is to continue farming. Accordingly, that sale would not be a "comparable sale" in the context of a hypothetical sale among equals, and, as a result, not indicative of the value of the property to a hypothetical seller who was capable of developing it (i.e., who would have had a higher walk away point than the farmer). As a consequence, sales in which the specific circumstances—BATNA—of the respective buyer and seller are unknown may not be comparable and, therefore, the prices from

those sales are not useful for determining value. This, in turn, provides at least a partial explanation for why an appraiser's valuation may sometimes seem inconsistent with actual sales of similar assets or other perceived "real world" transactions (where the particular bargaining positions of the parties involved are often unknown).

In the absence of appropriate sales data, parties estimate their respective BATNA through use of either the income approach or cost (replacement) approach. The income approach values property by computing the present value of the estimated future cashflow as to that property (*Chapman Glen*, 140 T.C. at 327). Each party's property-specific net present value (as determined by reference to its specific cost and revenue inputs and discount rates) determines his or her respective BATNA. A rational seller, under no obligation to sell, will not accept an offer that is less than the net present value of the receipts to be earned by continuing to use the property for its highest and best use, and vice versa. Under the cost approach, meanwhile, a party's BATNA is measured by determining the cost to reproduce the property, less applicable depreciation or amortization (*Id.*). Said differently, a rational buyer who could re-create the property at issue for X will not pay the seller X+$1 for it.

In short, the price at which property would change hands in a hypothetical transaction among fully informed buyers and sellers must properly take into account the respective bargaining position of each party to accurately determine that property's full and fair market value (*See, e.g., Bank One Corp. v. Commissioner*, 120 T.C. 174, 332–33 (2003) (rejecting expert's analysis when it was "was skewed improperly towards the price that a willing buyer would want to pay…as opposed to the balanced price that a willing buyer would have to pay for the swap in order for a willing seller to sell the swap to the willing buyer"), *aff'd in part, vacated in part, and remanded on another issue sub nom*; *Crocker v. Commissioner*, T.C. Memo. 1998-204, slip. op. 98–99 ("[T]he test of fair market value rests on the concept of a hypothetical willing buyer AND a hypothetical willing seller. Ignoring the views of the willing seller is contrary to this well-established test, and, as mentioned above, may be fatal.") (emphasis in original)).

Principle 4: Substitution Principle: Always the Bridesmaid, Never the Bride

The principle of substitution is the economic law that "a buyer will not pay more for one property than for another that is equally desirable." (Appraisal Institute, *The Appraisal of Real Estate* 25 (15th ed. 2020)). If Property A and Property B are identical in every way—except that Property A costs $1 million while Property B costs $1.2 million—a buyer would not pay the additional $200,000 to buy Property B. By its nature, the principle of substitution is not a valuation method. Instead, it is simply a reflection of a buyer's bargaining position and, therefore, attaches to the results of one of the three valuation methods discussed above (*Corning Place Ohio, LLC v. Commissioner*, T.C. Memo. 2024-72, at *19; *JL Minerals, LLC v. Commissioner*, T.C. Memo. 2024-93, at *37-38; *Buckelew Farm, LLC v. Commissioner*, T.C. Memo. 2024-52, at *34; *see also* Appraisal Institute, Appraisal Institute, *The Appraisal of Real Estate* 25 (15th ed. 2020) ("The principle of substitution is fundamental to all three traditional approaches to value—sales comparison, cost, and income capitalization.")).

The principle of substitution does not negate the arm's length standard as applied to the sales comparison approach. As above, for instance, the principle of substitution is silent as to why the owner of Property B would sell it for $1 million when his/her continued use of it has an apparent value of $1.2 million. While that example presumes that Property A and Property B are "equally desirable," it says nothing about if the buyer and seller are equally capable, equally capitalized, or equally experienced—that is, the owner of Property B may be able to put it to a use that the buyer is not capable (i.e., the buyer is not a market participant for that use). As another example, assume the highest and best use of the property at issue in an estate tax case is for the extraction and sale of minerals, and that the IRS claims its fair market value is $20 million based on the income method. If the taxpayer, relying on the sales comparison approach, shows there were 50 sales of identical-sized properties for $1 million, but that is all the taxpayer's expert knows about the sales, then none of the 50 sales could be used as a basis for applying the sales comparison approach. And the principle of substitution also does not apply to those sales, however enticing to rely upon. The bargaining position of the sellers in those sales is unknown—it could be, feasibly, that all 50 sales were made by non-market participant farmers who

lacked the capital to exploit the properties' minerals. For these reasons, the principle of substitution is always a bridesmaid—it is a principle that focuses on one party to a transaction, not a method for determining valuation.

Principle 5: Income/DCF Method to Value Income-Producing Property Rarely Constitutes a Business Valuation

Tax law did not create the three methods of valuation—but it must follow them. Frequently, the argument is made that the discounted cash flow income method (DCF) cannot be used to determine the fair market value of real property or an asset in the tax context because the income method values businesses, not property or other assets. If true, then there would only be two methods of valuation of assets for tax purposes, even for income-producing assets. This is not the case as industry relies on the DCF to value income producing assets ranging from real property to patents on a daily basis, without considering those assets a "trade or business". Further, tax laws require many elements to be satisfied for an activity to rise to the level of a "business". To claim otherwise is the tax tail wagging the real world dog which flies in the face of taxpayers' ability to structure their affairs and value their assets in a negotiated transaction.

If performing a DCF analysis is a "business valuation" and not an appropriate measure by which to value an income-producing property, then it should follow that such an analysis could not be used in court or by companies to value properties or other income-producing assets. That is not the case. For example, in *Estate of Mitchell* (T.C. Memo. 2011-94, at *7), the Court stated that "[a]ny property that generates income can be valued using the income capitalization approach." In particular, the Court found the leasing of a beachfront property to be "an income-producing activity that put the land to its best use." (*Id*. at *8). The Court did not then determine that it was instead valuing a vacation rental business—it used the income approach to value this real property based on the cash flows it would generate. The same thinking would apply to real property whose highest and best use is the extraction and sale of minerals, as the income method properly computes the net present value of the "cash flows" from such minerals. (*Whitney Benefits v. United States*, 18 Cl. Ct. 394, 409–10 (1989). In *Whitney Benefits*, the enactment of a federal statute barred mining on a particular property. The landowner brought a governmental takings action based on the property having a highest-and-best use as a coal mine. The Court approved Whitney Benefits' use of the income method to measure the value of the coal reserves sacrificed, holding:

"This case involves coal reserves, the value of which can be measured only by their ability to produce income. Simply stated, an operator's interest in a mineral estate is a compensable property interest. As the court in *Foster* explained "the value placed on an operator's interest is not compensation for the consequential damages of lost business profits; it is compensation for the taking of an interest in real property."…

The case at hand involves coal reserves, the value of which can only be measured by their ability to produce income. Lost profits, on the other hand, would be compensation for value added to the property taken by the plaintiffs' location and goodwill, their management skill, and all the potential risks and opportunities that make up the concept of profit." (*Id.*).

To further demonstrate the differences between business valuation and valuation of income-producing property, consider capital assets like equipment. If an oil company owns several pieces of drilling equipment, those are assets on the company's balance sheet thatadd to a company's value. In contrast, if that same oil company was valuing a potential drilling site using the DCF income approach, the need for a new drill would *reduce* the net present value of that property for the oil company. And the oil company using the DCF method to value a potential drilling site would not necessarily include as the cost of equipment in the DCF it already owns because that would skew the results of the net cash flows. Finally, the oil company would not consider the value of one site the value of its entire "business". Thus, there are many assets of a business, including workforce and customer lists, that are ignored in a "cash-flow" only analysis. In its most basic form, the DCF does what it says it does—values the cash flow of an asset by stripping away the costs incurred to create that cash flow so the potential investor can analyze the return the asset will generate. The tax community needs to trust the results of the primary valuation method industry and the appraisal community relies upon for income-producing assets.

Next, opponents to DCF analysis in property valuation often raise some version of the argument: “no one would pay the full amount resulting from a DCF analysis because they would not break even and start to realize profit for several years.” For starters, this argument omits context. This argument fails to ask the corollary question of why the seller in this context would accept anything less than the future cash flows would suggest. In any event, if taken to its logical conclusion, the flawed argument would say no lawyer reaps a profit as a lawyer until his or her student loans are paid off. If that argument carried any weight, no company would ever purchase any asset or other business at any cost that could not be recouped immediately. And if that was the case, the sale was under duress. Moreover, often times the buyer and seller are not in fact identical, and possess different bargaining positions and/or knowledge that allow them to value the exact same property differently. If, for instance, Amazon spends $10 million on a large property on which it wants to build a warehouse, it may not “break even” for years—until its warehouse is fully operational and can generate enough income to surpass *all* cash outlays. Why would Amazon agree to transactions like that “just to break even” in 20 years?The simple answer: they are planning to do a lot more than just “break even"—they are “trading present dollars for the expectation of receiving future dollars.” (Appraisal Institute, Appraisal Institute, *The Appraisal of Real Estate* 413 (15th ed. 2020)). An owner can reap profits in only a short time frame by generating revenue that exceeds the cost of borrowing to acquire the property and other expenses. In short, the income method is the only method the valuation community gives us to determine the net present value of an income-producing asset. The tax community must embrace its results as such results create a range of value that is acceptable to a hypothetical buyer and seller.

Conclusion

This article is meant to spur further analysis by tax practitioners into five critical rules of valuation that are frequently misunderstood or misapplied by the tax community. By properly applying these five valuation principles, the IRS and taxpayers should be able to resolve more valuation disputes amicably and without court involvement.