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When is Fair Market Value Determined?

Estate of Helen M. Noble v. Commissioner

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Note to reader: This is a lengthy article. You may wish to print this issue of *Value Matters™* in order to review rather than read the article on screen.

In *Estate of Noble v. Commissioner*[i], the Tax Court gave little attention in its 30-page opinion to the reports of two experts. Instead, it focused the decision on a discussion of a sale of the subject block some 14 months after the date of death (the valuation date). Two important issues are raised by *Noble*.

1. The relevance of post-valuation date transactions or events ("subsequent events") in determining the fair market value of non-publicly traded interests; and,
2. The meaning of the concept of "arm's length transactions" in the context of determinations of fair market value.

This article addresses both issues in the context of *Noble* and within one appraiser's understanding of the meaning of fair market value.

CASE BACKGROUND

The subject of the valuation was 116 shares of Glenwood State Bank ("the Bank"), representing 11.6% of its 1,000 shares outstanding at September 2, 1996, the date of death of Helen M. Noble ("the Estate"). Glenwood State Bank was a small ($81 million in total assets), over-capitalized (17.5% equity-to-assets ratio), low-earning bank (3% to 5% return on equity for the last four years) located in rural Glenwood, Iowa. Historical growth of the balance sheet had been anemic prior to the valuation date, and prospects for future growth were similar. Management's philosophy, implemented over many years, was to reinvest all earnings back into the Bank and to pay no shareholder dividends. There was no market for the Bank's shares.

The Estate's 11.6% block of the Bank's stock was the only block of the Bank that Glenwood Bancorporation, the parent holding company ("the Company"), did not own at the valuation date. The Company had, over a period of many years, gradually consolidated its ownership of the Bank to this point. The Company's historical philosophy had mirrored that of the Bank, and no dividends were paid historically or anticipated for the near future.

In short, the subject 11.6% interest in the Bank was not a very attractive investment, when viewed in terms of then-current expectations for growth, dividends, and overall returns for publicly traded bank shares.

Two appraisals were submitted to the Tax Court in this matter:

- *Internal Revenue Service.* William C. Herber of Shenehon & Company ("Herber") presented a valuation which concluded that the fair market value of the subject 11.6% interest in the Bank was $1,100,000, or $9,483 per share. The marketable minority value concluded by Herber was $13.1 million, and his marketability discount was 30%.
- *The Estate.* Z. Christopher Mercer, ASA, CFA of Mercer Capital ("Mercer", the writer of this article) presented an appraisal which concluded that the fair market value of the subject interest was $841,000, or $7,250 per share. The marketable minority value concluded by Mercer was $12.7 million, and his marketability discount was 43%.

In addition, Glenwood State Bank had obtained an appraisal from Seim, Johnson, Sestak & Quist, LLP, an accounting firm, of the fair market value of the same shares as of December 31, 1996 ("the Seim Johnson Report"). This report (issued May 15, 1994) concluded that the fair market value of the shares was $878,004 ($7,569 per share). The Estate originally reported the fair market value of the shares at $903,988 ($7,793 per share based on then-current book value less a minority interest discount of 45%). The Estate sold its 116 shares to Glenwood Bancorporation on October 24, 1997, almost 14 months after the valuation date, for $1.1 million.[ii]

Focusing on the expert reports of Herber and Mercer, the total difference in value between the two appraisals of the 11.6% interest was $259,000. Herber's result was about 30% higher than Mercer's. Relative to many valuation disputes, the differences were fairly small. Both appraisers agreed on the relative unattractiveness of the subject shares as an investment. Herber's appraisal represented 73% of the Bank's book value, while Mercer's appraisal represented 56% of book value.

Given the similarity of conclusions at the marketable minority level, the major difference in valuation conclusions between the two appraisers was the difference in their concluded marketability discounts. This was an opportunity for the Court to address this issue in a meaningful way; however, that did not occur. We present information here not found in the opinion to inform the reader of the rest of the story.

RELEVANCE OF SUBSEQUENT EVENTS

After discussing two sales of minority interests of the Bank's stock, one of which occurred some 15 months *prior* to the valuation date (at $1,000 per share), and the other of which occurred about two months prior to the valuation date ($1,500 per share), the Court's decision notes:

> As to the third sale, which occurred on October 24, 1997, approximately 14 months *after* the applicable valuation date, we disagree with petitioners that only sales of stock that predate a valuation date may be used to determine fair market value as of that valuation date. The Court of Appeals for the Eighth Circuit, the court to which an appeal of this case most likely lies, has held specifically that "In determining the value of unlisted stocks, actual sales made in reasonable amounts at arm's length, in the normal course of business, *within a reasonable time before or after* the basic date, are the best criterion of market value."[iii] [citations omitted, emphasis added][iv]

The Court made no mention as to what constitutes a "reasonable time" before or after a valuation date. It went on to say, after further discussion of the subsequent transaction, that:

> When a subsequent event such as the third sale before us is used to set the fair market value of property as of an earlier date, adjustments should be made to the sale price to account for the passage of time as well as to reflect any change in the setting from the date of valuation to the date of sale. [citing *Estate of Scanlan*[v]] These adjustments are necessary to reflect happenings between the two dates which would affect the later sale price vis-à-vis a hypothetical sale on the earlier date of valuation. These happenings include: (1) Inflation, (2) changes in the relevant industry and the expectations for that industry, (3) changes in business component results, (4) changes in technology, macroeconomics, or tax law, and (5) the occurrence or nonoccurrence of any event which a hypothetical reasonable buyer or hypothetical reasonable seller would conclude could affect the selling price of the property subject to valuation (e.g., the death of a key employee [citing *Estate of Jung*[vi]].

The record before us does not establish the presence of any material change in circumstances between the date of the third sale and the applicable valuation date. [emphasis added][vii]

The Court noted that the 116 shares sold for a total of $1.1 million, or $9,483 per share, on October 24, 1997. In response to the above guidance regarding "the happenings between the two dates" the Court stated: "While the record does not accurately pinpoint the appropriate rate to apply for that purpose [inflation], the Bureau of Labor Statistics has stated that the rate of inflation during each of the years 1996 and 1997 was slightly less than 3 percent."

The five factors noted above are now considered:

1. *Inflation*. The Court did its own independent research on inflation, lowering the subsequent transaction price to $1,067,000 ($1,100,000/(1 + 3%)). This reduction of $33,000, or $284 per share, was made by the Court to account for the effect of inflation during the period between the valuation date and the date of the subsequent transaction despite specific expert advice arguing against the appropriateness of this adjustment for the change in inflation.[viii]

2. *Changes in the Relevant Industry and the Expectations for that Industry*. The Court made no investigation of changes in industry expectations. However, the banking industry experienced very strong results in the public markets between September 2, 1996 and October 24, 1997, with the NASDAQ Bank Index increasing some 75% over the period. This compared with a 45% increase in the S&P 500 Index over the same period. So the base market evidence used by both appraisers would have shown considerably higher price/earnings multiples and price/book multiples 14 months later. This certainly could have had an influence on value at the time of the subsequent sale. Clearly, consideration of the change in market conditions could have had a significant impact on value during the interim period, and should be taken into account if one is considering a subsequent transaction as direct evidence of fair market value as of an earlier date. The Court did not do this, citing the absence of such post-valuation date evidence in the record. Were the appraisers somehow at fault for not discussing post-valuation date market performance? More frequently, appraisers are criticized for engaging in such analysis.

3. *Changes in the Business Component Results*. The Court made no investigation of changes in business component results. However, it is clear from the record that the Bank was earning at the rate of about $700,000 per year and paying no dividends to shareholders, so just over a year later, its book value would have been about $700 per share higher. This foreseeable change, which was noted in the Mercer Report, was not considered by the Court.

4. *Changes in Technology, Macroeconomics, or Tax Law*. The Court did no investigation of changes in these factors. Suffice it to say that there were almost certainly changes in one or all of these areas.

5. *The Occurrence (or Nonoccurrence) of Events that Reasonable Investors Would Consider Impact Value*. The Court *did consider* the subsequent sale of 116 shares of Glenwood State Bank by the Estate. However, the Court *did not consider* another subsequent event which occurred virtually simultaneously with the subsequent transaction, that materially changed the value of the 116 shares of Glenwood State Bank. The parent company, Glenwood Bancorporation, decided that it wanted the Bank to pay dividends after many years of not paying dividends. As discussed in the Mercer Report, there was a strong aversion to paying dividends from the Bank to the Company. This change of philosophy would also have changed the amount that Glenwood Bancorporation was willing to negotiate for a transaction for the 116 shares of the Bank's stock. Immediately after the transaction, when the Company owned 100% of the Bank's shares, a dividend of $1,200,000, or $1,200 per share on the previously outstanding 1,000 shares was paid (between October 24, 1997 and December 31, 1997). This dividend, if received by the Estate as a continuing shareholder, would have represented a yield of 12.7% based on the subsequent transaction price of $9,483 per share. As was discussed in the Mercer Report and in Mercer's trial testimony, this change had the effect of creating a significant change in the value of the shares relative to September 2, 1996.[ix]

Neither Mercer nor Herber provided an analysis of events in the stock market, in the market for bank stocks, or of detailed financial performance of Glenwood State Bank subsequent to the valuation date. Both appraisers were providing valuation opinions as of September 2, 1996. Mercer mentioned the subsequent transaction in his report, and both appraisers mentioned the transactions prior to the valuation date. The Mercer Report discussed the subsequent change in dividend policy in detail.

It should be clear from the above analysis of the factors mentioned by the Court, that there were material changes, virtually all positive regarding the value of 116 shares of Glenwood State Bank, between the valuation date of September 2, 1996 and the subsequent transaction on October 24, 1997.

The Court's analysis of subsequent transactions raises several questions:

- If one is to consider a subsequent transaction directly in an appraisal as of a specific date, what is a "reasonable time" for consideration of that transaction? Evidently, 14 months was "reasonable" to the Court. What about two years? Or three years or more?
- When is a valuation ever over?
- Is there a need for a revaluation in light of the five guidance factors above every time appraisers encounter subsequent transactions?
- What is an appraiser who is valuing a business or business interest as of a current valuation date to do regarding subsequent transactions that have not occurred when he or she is rendering the opinion?[x]
- Is it reasonable to impeach an appraisal done timely based on transactions that occur subsequent to the valuation date? After all, neither the appraiser conducting such a timely appraisal nor hypothetical or real willing buyers and sellers would have had knowledge of such subsequent events.
- Do real-life investors have the opportunity for such a free look-back?[xi]
- Is the consideration of subsequent events as "evidence of fair market value" as of an earlier date merely a way for an appraiser or a court to reach a pre-determined conclusion?
- The underlying question is, what kind of analysis does the Tax Court desire in a determination of fair market value as of a given valuation date?

It is this author's understanding of the investment process that investors consider all relevant information, including that which is known and that which is reasonably foreseeable, or reasonably knowable, up to the moment that an investment is executed. After that, there are no second chances. Real-life investors know that one of only two things will happen with respect to the return performance of any particular investment:

- It will perform at less, equal to, or greater than the original expectations over the expected investment horizon; or
- The actual investment horizon will be shorter or longer than original, expected investment horizon, and performance will be equal to, less than or greater then original expectations.

The investment's ultimate performance will be the (net) result of many factors, including the actual performance of the underlying entity, changes (favorable or unfavorable) in national economic conditions or specific industry conditions, the general level of the stock markets and the particular performance of a particular industry, and the other factors noted above.

The Court's decision in *Noble* causes great uncertainty for both appraisers and taxpayers.

ARM'S LENGTH TRANSACTIONS

The second fundamental issue in *Estate of Noble* relates to the nature of arm's length transactions. This author understands the nature of the standard of value known as fair market value to consist of:

- A hypothetical willing buyer and a hypothetical willing seller (presumably independent of each other),
- Both of whom are fully (or at least reasonably) informed about the subject of investment,
- Neither of whom is acting under any compulsion,
- And both of whom have the capacity to engage in a transaction involving the subject interest,
- Engage in a hypothetical transaction at the fair market value (cash-equivalent) price.

A Four-Factor Test for Bargaining Parity

A transaction involving the characteristics noted above would be an "arm's length" transaction in the context of fair market value. Fair market value transactions presume bargaining parity. Note from this definition that an actual transaction in non-publicly traded stock would not meet the definition of arm's length transactions in the context of fair market value if one or more of the following four conditions of bargaining parity are not met:[xii]

1. ***Independence.*** If parties are related in some way, it is clear that transactions between them should be viewed with skepticism. It is simply not possible to know the extent of relationships or how those relationships could impact the pricing of a particular transaction.
2. ***Reasonably and Equally Informed.*** If both parties are not reasonably (equally) informed about the facts and circumstances related to the investment, a transaction should also be viewed with skepticism. Clearly, if one party has a significant information advantage over the other, a transaction is not likely to occur at fair market value, since the party lacking the information lacks equal bargaining power. As will be shown below, the Court did not consider a known inequality of information with respect to the third transaction which should have excluded it from consideration as evidence of fair market value *at any time*.
3. ***Absence of Compulsion.*** If one or both of the parties is acting under any compulsion to engage in a transaction, it is generally understood that a transaction is not evidence of fair market value. A party acting under compulsion would lack parity in bargaining power relative to the party who can view the investment opportunity dispassionately and objectively.
4. ***Financial Capacity to Transact.*** If one party lacks the financial capacity to engage in a transaction, the results of negotiations may not reflect equal bargaining power.

It will be helpful to review the concept of arm's length transactions in the context of these four essential elements of bargaining parity, i.e., through the four factor test outlined above. Although this test was not employed explicitly in this manner in the Mercer Report, it was employed implicitly in the discussion and analysis of the three transactions.

The Court's Analysis of Three Transactions

The Court paraphrased *Polack v. Commissioner*[xiii] and *Palmer v. Commissioner*[xiv] in introducing its discussion of arm's length transactions:

> While listed stocks of publicly traded companies are usually representative of the fair market value of that stock for Federal tax purposes, the fair market value of non-publicly traded stock is "best ascertained" through arm's-length sales near the valuation date of reasonable amounts of that stock as long as both the buyer and the seller were willing and informed and the sales did not include a compulsion to buy or to sell.[xv]

While this guidance is flawless as far as it goes, it needs to be viewed, as just indicated, through the filter of the four factors of bargaining parity.

The Court's decision discusses three transactions in the stock of Glenwood State Bank, the two occurring before the valuation date and the subsequent transaction some 14 months after the valuation date. The Court determined that the two prior sales were not at arm's length:

> As to the two prior sales of stock in this case, we also are unpersuaded that either of those sales was made by a knowledgeable seller who was not compelled to sell or was made at arm's length.[xvi]

The Court actually made two additional comparisons in reaching its conclusion regarding the two prior sales. First, the decision notes that they were both smaller in size (1% or less of the shares) than the subject interest (11.6%). And second, it was noted that neither of these two transactions was made based on an appraisal.

The Court discussed the subsequent transaction at some length at this point:

> Petitioners try to downplay the importance of the subsequent (third) sale of the estate's 116 Glenwood Bank shares by characterizing it as a sale to a strategic buyer who bought the shares at greater than fair market value in order to become the sole shareholder of Glenwood Bank. Respondent argues that the third sale was negotiated at arm's length and is most relevant to our decision. We agree with respondent. Although petitioners observe correctly that an actual purchase of stock by a strategic buyer may not necessarily represent the price that a hypothetical buyer would pay for similar shares, the third sale was not a sale of similar shares; *it was a sale of the exact shares that are now before us for valuation. We believe it to be most relevant that the exact shares subject to valuation were sold near the valuation date in an arm's length transaction and consider it to be of much less relevance that some other shares (e.g., the 10 shares and 7 shares discussed herein) were sold beforehand.* The property to be valued in this case is not simply any 11.6% interest in Glenwood Bank; it is the actual 11.6-percent interest in Glenwood Bank that was owned by decedent when she died. [emphasis added][xvii]

It would appear that the Court determined that because the same 116 shares sold 14 months after the valuation date for $9,483 per share, they were therefore worth the same $9,483 per share (less a discount for inflation) at the date of death some 14 months prior.

In reaching this conclusion, the Court did something that both appraisers warned against, in effect, assuming that *the exact transaction that occurred was foreseeable*.[xviii,xix] There is a world of difference in the relative risk assessment by hypothetical willing buyers and sellers between two different situations: 1) it is *reasonably foreseeable* that a transaction will occur at a *specific price* and at a *specific time* in the future; or 2) it is *generally foreseeable* that a transaction, or a variety of potential transactions, could occur at some *unknown and indefinite time (or times)* in the future. The Court's analysis effectively assumed the first situation existed at the valuation date when, in fact, the second situation existed. In doing so, the Court ignored the risks of the expected investment holding period from the perspective of hypothetical buyers and sellers at the actual valuation date.

The Court also did not believe that Glenwood Bancorporation had specific motivation to purchase the shares which would cause it to pay more at the subsequent date.

> Moreover, as to petitioners' argument, we are unpersuaded by the evidence at hand that Glenwood [Bancorporation] was a strategic buyer that in the third sale paid a premium for the 116 shares. *The third sale was consummated by unrelated parties (the estate and Bancorporation) and was prima facie at arm's length.* In addition, the estate declined to sell its shares at the value set forth in the appraisal and only sold those shares 5 months later at a higher price of $1.1 million. Although the estate may have enjoyed some leverage in obtaining that higher price, as suggested by Mercer by virtue of the fact that the subject shares were the only Glenwood Bank shares not owned by the buyer, this does not mean that the sale was not freely negotiated, that the sale was not at arm's length, or that either the estate or Bancorporation was compelled to buy or to sell. [emphasis added] [xx,xxi]

The Court is assuming that transactions occurring between unrelated parties provide prima facie evidence of their arms' length natures. However, independence is only one of the four factors insuring bargaining parity and therefore, arms' length transactions. The Court asked Mercer about the nature of this particular transaction. Mercer testified that while a transaction may appear to be at arm's length, it should not be evidence of fair market value if there is an inequality of information regarding the potential transaction.[xxii]

APPLYING THE FOUR-FACTOR TEST OF BARGAINING PRIORITY

Another Analysis of the Three Transactions

The Mercer Report provided background information for the two transactions prior to the valuation date (at page 22) as follows:

1. One transaction involving seven shares occurred in July 1996 at $1,500 per share (approximately 11% of book value). The seller was Linda Green, the daughter of a long-time shareholder. Upon attempting to contact Ms. Green to discuss the circumstances of her sale of stock, we learned that she had died within the last year.
2. Another transaction occurred in June 1995 when a director of the Bank sold ten shares for $1,000 per share. The price represented approximately 8% of December 31, 1994 book value. Management indicated that the director, Mr. Robert Hopp, desired to turn his non-dividend paying stock in the Bank into an earning asset and offered it to the Bank. The agreed upon price was $1,000 per share. Bank management stated that they knew of no compulsion to sell on Mr. Hopp's part (financial or otherwise) and that he remained a director of the Bank until his death several years later. As a director, we should be able to assume that Mr. Hopp was reasonably informed about the Bank and the outlook for its performance, as well as about prior transactions in the stock. We were unable to contact Mrs. Hopp to discuss her recollection of the circumstances of the transaction; however, we have no reason to question the recollections of the Bank's chairman.

The Mercer Report also discussed the subsequent transaction at some length, and analyzed it in light of the facts and circumstances in existence at the subsequent transaction date, at least as they related to Glenwood State Bank and Glenwood Bancorporation. As noted above, the Mercer Report indicated that a significant change in policy would have materially changed the value of the subject 116 share block. Glenwood Bancorporation, after many years of not desiring to upstream dividends from Glenwood State Bank, changed its mind. The reason for this change was a decision to build a new bank in Council Bluffs, Iowa, to enter the greater Omaha metropolitan market. This decision required capital that was lying dormant in the Bank, and would require that significant dividends be paid by the Bank to the Company. Importantly, Glenwood Bancorporation did not inform the Estate's representatives of this change in policy prior to the transaction. So the second factor of the four-factor bargaining parity test was not met. This was noted in the Mercer Report.

The Mercer Report did indicate that such a change in dividend policy could occur at Glenwood Bancorporation (i.e., was reasonably knowable); however, the analysis indicated that no rational, independent investor would assume that the change would occur in such a short time as a year or so, and that if dividends were to be paid, there would be a material, upward pressure on the value of the Bank's minority shares.

It is important to place this subsequent change in dividend policy in perspective. The following table, provided in the Mercer Report in the discussion of the subsequent transaction, should indicate clearly that if the dividend policy had been in place at the valuation date, the valuation conclusion should have been significantly higher than either the Mercer conclusion or the conclusion of the Herber Report or that of the Court based on the subsequent transaction.

Subsequent Dividends Paid by Glenwood State Bank					
			Dividends	Pro Forma	Book Value
Dividends Paid	Dollars	Per Share	116 Shares	Book Value*	116 Shares
Between 10/24/97					
and 12/31/97	$1,200,000	$1,200	$139,200	$15,251,000	$1,769,116
1998	$1,000,000	$1,000	$116,000	$15,009,000	$1,741,044
1999	$3,000,000	$3,000	$348,000	$12,676,000	$1,470,416
2000	$500,000	$500	$58,000	$13,047,000	$1,513,452
2001	$1,150,000	$1,150	$133,400	$12,678,000	**$1,470,648**
Total Dividends	$6,850,000	$6,850	**$794,600**		

** Assuming the October 1997 Transaction had not occurred and the dividends were paid*

As noted above in the discussion of the nature of subsequent transactions, something material changed between the date of death and the subsequent transaction. Glenwood Bancorporation decided that it desired to receive dividends from Glenwood Bank after many years of not having the Bank pay dividends. This change in policy necessarily had a change on the value of the Bank's shares since, other things being equal, an investment that pays dividends is worth more than one that does not pay dividends.

The Court's analysis does not mention the remaining, critical element of a fair market value transaction – that both parties be reasonably (and equally) informed about the investment. This is a point that Mercer addressed both in his direct testimony (report) and in cross-examination.

Given that the Estate sold 116 shares for $1.1 million on October 24, 1997, consider the following regarding equal and reasonable information:

- Did the Estate's representatives know that, between that date and December 31, 1997, the Company would cause the Bank to declare and to pay dividends totaling $139,200 on those very same 116 shares? Management of the Company did not inform the Estate's representatives of this fact or intention.
- Did the Estate's representatives know that the Company would declare and pay nearly $800,000 in dividends ($6,850 per share) on the Estate's 116 shares between the sale date and the end of 2001? Management of the Company did not inform the Estate's representatives of this fact or intention.
- Following the payment of $6,850 per share in dividends over the next four years, the 116 shares owned by the Estate would have had a then (2001) book value of $12,648 per share (relative to the sale price in 1997 of $9,483 per share).

In fact, both the Seim Johnson and Herber Reports stated the following about the expectation of future dividends:

> "Glenwood State Bank has not paid any dividends since May of 1984 *and has indicated no intention to pay dividends in the near future*. This decreases the value of the common stock, and, also, it adversely impacts a willing buyer's decision to purchase the stock." [emphasis added, Seim Johnson Report at page 7]

> "As of September 2, 1996, Glenwood State Bank had not paid a dividend in over a decade *and had no plans to pay dividends in the future*." [emphasis added, Herber Report, page 15]

These valuation reports, prepared just shortly after the date of death (Seim Johnson) and much later (Herber), affirm the stated policy of the Bank that was provided to Mercer Capital during interviews held in 2004. They also affirm the fact that there was a significant change in policy between the date of death and the time of the third transaction some 14 months later.

The point of this discussion is that there was a material change of facts between the valuation date and the subsequent transaction and this change of facts was known to only one of the two parties to the transaction. This causes the subsequent transaction to fail the four-factor bargaining parity test and disqualifies the transaction as an arm's length transaction in the context of a determination of fair market value. In fact, had the change of policy been known, it is almost certain that the subsequent transaction would have occurred at a price substantially higher than the actual price of $9,483 per share.

The four-factor bargaining parity test is summarized for the three transactions below.

Transactional Data	**Transactions Prior to the Valuation Date**		**The Subsequent Transaction**
Seller	Robert Hopp (Director of Bank)	Linda Green	Estate of Helen Noble
Transaction Date	June 1995	July 1996	October 24, 1997
Buyer	Glenwood Bancorporation	Glenwood Bancorporation	Glenwood Bancorporation
Number of Shares	7 Shares	10 Shares	116 Shares
Price per Share	$1,000 per Share	$1,500 per Share	$9,483 per Share
Price/Book Value	8% of Book Value	11% of Book Value	69% of Book Value
Dividends Reasonably Foreseeable?	No	No	No to Seller / Yes to Buyer
Four-Factor Bargaining Parity Test			
1. Independent?	Yes	Yes	Yes
2. Reasonably (Equally) Informed?	Yes	Unknown	No
3. Absence of Compulsion?	Yes	Unknown	Yes
4. Financial Capacity to Transact?	Yes	Unknown	Yes
Meets Bargaining Parity Test	**Yes**	**Unknown**	**No**

It would appear that the prior transaction involving Mr. Hopp, the former director of Glenwood State Bank, would meet the four-factor test. It occurred at a very low price (relative to book value) at a time when a knowledgeable, independent buyer had no expectations of future dividends or other avenues to liquidity within a reasonable timeframe.

It is simply unknown if the second prior transaction meets the four-factor test.

However, it is clear that the subsequent transaction does not meet the test. The parties were clearly *not* equally informed about the change in dividend policy that Glenwood Bancorporation planned to implement immediately following the transaction.

Thus, the question is, how can a subsequent transaction that would not pass the four-factor test for arm's length bargaining parity at the date it occurred provide evidence of the fair market value of shares some 14 months prior to that date? In the opinion of the author, it cannot.

The Court considered that the sale was negotiated at arm's length as prima facie evidence that the subsequent transaction was evidence of fair market value. However, it should be clear from the analysis above, which was presented to the Court in the Mercer Report, that there was a material change of circumstances between the date of death the date of the subsequent transaction. It should further be clear that the parties engaging in that subsequent transaction were not dealing with the same information about the value of the subject interest.

CONCLUSION

Estate of Noble raises two very important issues for business appraisers:

- The relevance of subsequent transactions (or events in determinations of value as of a given valuation date
- The nature of arm's length transactions in fair market value determinations

Should transactions (or events) occurring subsequent to a given valuation date be considered in the determination of fair market value as of that valuation date? If so, how should they be considered in the context of facts and circumstances in existence at the valuation date? How long after a given valuation date can information from a subsequent transaction be considered relevant? Opening the door to the routine analysis of subsequent transactions as providing evidence of valuation at earlier dates would seem to fly in the face of the basic intent of the fair market value standard of value.

Are transactions occurring between apparently independent parties prima facie evidence of arm's length transactions in the context of fair market value? The four-way test of bargaining parity introduced above questions the relevance of at least certain otherwise arm's length transactions as providing evidence of fair market value.

The questions and issues raised by *Estate of Noble* are important for appraisers and for taxpayers. Regarding subsequent transactions, it would seem that appraisers and the Tax Court should focus on events known or reasonably foreseeable as of the valuation date as the basic standard for fair market value determinations. Any other approach would seem to raise more questions than can be answered, and would seem to place at least one party in a valuation dispute at a distinct disadvantage.

Finally, regarding the nature of arm's length transactions, it would seem that a more definitive understanding of the nature of "arm's length" is needed than the mere fact that parties appear to be independent of each other. The four-way bargaining parity test above indicates that independence is only one of four factors needed to define an arm's length transaction characterized by equal bargaining power. ◆

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[i] *Estate of Helen M. Noble v. Commissioner*, T.C Memo. 2005-2, January 6, 2005.

[ii] In the final analysis, this fact was determinative of value in the Court's decision. There was surprisingly little discussion of any of the three valuation reports before the Court in Noble.

[iii] The Herber Report did not mention the subsequent transaction. The Mercer report mentioned the subsequent transaction, but did not rely on it in reaching its appraisal conclusion. Herber's conclusion, however, was identical to the value of the subsequent transaction. Mercer's report analyzed the subsequent transaction and placed it into perspective with his valuation-date conclusion, indicating that circumstances had changed between the valuation date with respect to expected dividend policy at Glenwood Bancorporation (and therefore, with respect to Glenwood Bank). Mercer noted that while Glenwood Bancorporation knew of this change in policy, it was not communicated to the Estate's representatives prior to the transaction.

[iv] *Supra*. Endnote i, pp. 21-22.

[v] *Estate of Scanlan v. Commissioner*, T.C. Memo. 1996-331.

[vi] *Estate of Jung v. Commissioner*, 101 T.C. at 431.

[vii] *Supra*. Endnote i, pp. 28-29.

[viii] The Court asked Mercer a direct question on the appropriateness of discounting a subsequent transaction to the valuation date "at interest."

> THE COURT: Okay. Another question for you. I asked you earlier about the possible use of the October transaction as a potential for a valuation. If one wanted to look at that and factor in an interest rate what rate would you use in order to factor that in?
>
> THE WITNESS: Well, let me answer it just one other – one slightly different way. If you look at our valuation, my valuation, that 841,000, and I understand that Mr. Herber's problem with talking about I and we, because we do that as firms, and you apply a 17 percent rate of return you would get to about , oh, a million. The 1.1 million, the 1.14 years implies about a 25 of 26 percent rate of return. That would not be unusual for an earlier [than anticipated] transaction.
>
> THE COURT: But you are looking at a rate of return. I am simply saying wouldn't you just factor, couldn't one just factor in an interest rate, in other words, like a discount rate for time value of money?
>
> THE WITNESS: Well, no, because the fact of the matter is an interest rate for the time value of money would not include premium for the risk of holding the stock for that period of time. So at the very least if you were going to do that to reverse back to the present you would build up a discount rate to 16, 18, 20 percent, or 26 percent, or some number, and bring that back to the present. The time value of money would not account for that risk.
>
> THE COURT: Okay.
>
> THE WITNESS: When you buy stock now, you have the risk going forward, and you don't know about the transaction.

[ix] Clearly, the conclusions of both appraisers would have been higher had there been any reasonable expectation of such dividends in the readily foreseeable future.

[x] As with the Seim Johnson Report, which was issued five months prior to the October 1997 transaction, and, obviously, did not take the potential subsequent transaction into account.

[xi] The answer to this question is "obviously not."

[xii] Mercer Z. Christopher, VALUING ENTERPRISE AND SHAREHOLDER CASH FLOWS – THE INTEGRATED THEORY OF BUSINESS VALUATION (Memphis, TN: Peabody Publishing, 2004). These issues are discussed at some length in chapter 8: "Fair Market Value vs. the Real World." www.integratedtheory.com.

[xiii] *Polack v. Commissioner*, 366 F.3d 608, 611 (8th Cir. 2004), affg. T.C. Memo. 2002-145.

[xiv] *Palmer v. Commissioner*, 62 T.C. 684, 696-698 (1974).

[xv] *Supra*. Endnote i, pp. 12-13.

[xvi] *Supra*. Endnote i, p. 20.

[xvii] *Supra*. Endnote i, p. 25.

[xviii] Counsel for the Internal Revenue Service asked Mercer a series of questions regarding the third transaction. The last question and answer was:

> Q. Right. And this stock was liquidated in slightly over one year.
>
> R. Sure. Hindsight is 20/20. I'm saying that [it] is not a reasonably foreseeable event that in 1.14 years that the stock would be sold at the price it was sold at, in my opinion.

[xix] Mr. Herber, the expert retained by the Internal Revenue Service, was asked directly about whether he thought the third transaction was foreseeable:

> THE COURT: Do you think that as of the valuation date that subsequent sale was foreseeable by a hypothetical buyer and seller?
>
> THE WITNESS: No.
>
> THE COURT: Why not?
>
> THE WITNESS: Because of the facts that are talked about in the report. They had not paid dividends. They did not want to sell the bank. There was definitely – you could not foresee that specific transaction.
>
> THE COURT: But could you foresee the fact that there would be some transaction with a period of time?
>
> THE WITNESS: Oh, yes, yes.

[xx] *Supra*. Endnote i, p. 25.

[xxi] First, the Court apparently assumed that the estate had benefit of the Seim Johnson Report. In fact, it was commissioned by Glenwood State Bank and was not provided to the estate's representatives (per counsel for the estate). Second, counsel for the estate did refer to Glenwood Bancorporation as being a strategic buyer. Mercer referred to Glenwood Bancorporation as "motivated" because of the dividend situation. Nevertheless, the Court was not persuaded.

[xxii] The Court's question was raised immediately following Mercer's "20/20 hindsight" comment quoted in Endnote xviii above.

> THE COURT: That sale, though, Mr. Mercer, as far as you know that was an arm's-length sale?
>
> THE WITNESS: Your honor, as far as I know it was an arm's-length sale, but let me be careful to answer a little further. An arm's-length sale does not necessarily provide evidence of fair market value even if the transaction occurs prior to the valuation date. An arm's-length sale with compulsion is – that's arm's-length, but there is compulsion [and it] would not qualify as evidence of fair market value. An arm's-length sale with lack of knowledge would not qualify as evidence of fair market value. And I'm suggesting that this transaction was an arm's-length sale with lack of knowledge.
>
> THE COURT: And specifically what was the lack of knowledge? I know you have testified earlier to it, but if you would repeat it, I would appreciate it.
>
> THE WITNESS: That the relationship between Glenwood Bank Corporation [Bancorporation], the likelihood that dividends would be paid in the future, or that I would have a chance to negotiate for this a favorable sale. The existence of Glenwood Bank Corporation, we don't know that anyone knew that Glenwood Bank Corporation even existed because the shareholders of the bank had no reason to know anything about it. They file separately to the Federal Reserve, you know, to the federal authorities.
>
> And the only reason we know about it is because we asked. And when we asked about the holding company, then we looked at the historical financial statements of the holding company. Now to show you the relationship between the bank and the holding company and the lack of interest of this management in paying shareholder dividends prior to the valuation date, there was over $400,000 of debt at the parent company, Glenwood Bank Corporation. It would have been an easy thing to do to upstream a dividend to pay that debt.
>
> Rather than do that and pay the dividend to the shareholder [the 11.6% that would go to the 11.6% interest holder in the Bank], they went and bought more stock in Glenwood Bank Corporation, putting $400,000 into Glenwood Bank Corporation and paying down that debt externally. That's a fact. That would not give me a great deal of conviction that I was likely to get dividends any time real soon.

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