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Fair Market Value in the Tax Law: Replacement Value or Liquidation Value†

Daniel S. Goldberg*

I. Introduction

The Internal Revenue Code and Regulations use the concept of "fair market value" to place a monetary value on economic benefits received or paid in a form other than cash. Fair market value is both the measure of income for the receipt of property¹ and the measure of deductions for losses² or payments in the form of property.³ In the estate and gift tax area, fair market value is the measure of property included in a decedent's estate⁴ and the measure of a gift of property in a lifetime transfer.⁵

The fair market value of property is generally 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 or sell and

† Citation to tax cases includes parallel cites to United States Tax Cases and American Federal Tax Reports to facilitate source location by tax practitioners. All references to the Code are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated, and all references to Regulations are to the Treasury Regulations issued thereunder.

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2. See infra text accompanying notes 91-106.

3. See infra text accompanying notes 81-90 (business deductions) & 107-64 (charitable contribution deductions).

4. See infra text accompanying notes 54-80.

5. Id.
both having reasonable knowledge of relevant facts." The definition, however, fails to resolve the fair market value issue in many cases. Value may depend on the identities of the buyer and seller as well as on what they intend to do with the property being valued. The same piece of property may change hands at different prices, depending on the market in which it is sold. For example, an article of tangible personal property that costs $5.00 to make may be sold by a manufacturer to a wholesaler for $10.00. The wholesaler may in turn sell it to a retailer for $15.00, who may sell it to his retail customer for $20.00. The same property may be sold back to the retailer for $14.00 and then resold to a second retail customer for $20.00.

Even though all of the above transactions were at arm’s length and involved willing buyers and willing sellers, they involved several sales prices. The price differential can be attributed to the market in which each sale took place. Therefore, a determination of fair market value under the willing buyer/willing seller test cannot be made without first knowing the market in which the transaction will take place.

Separate and distinct markets exist for certain kinds of property, but most taxpayers generally have access to only one of those markets. A casual purchaser of personal property typically has access only to the retail market. The typical customer purchases property from a dealer who receives a normal retail markup. Similarly, a casual seller of per-


7. The retail markup of the dealer represents the spread between the retail and the wholesale prices. The spread is not necessarily all profit to the dealer. The dealer may have substantial carrying, rent, sales, advertising, and other costs. These costs associated with the sale of personal property may be high; therefore, the markup charged by the dealer may be high.
sonal property usually has access only to the wholesale market. In some situations he may be completely excluded from selling in the retail market because of barriers to entry. Therefore, he must sell his property to a dealer.

The fair market value issue arises in the context of valuing property in the hands of a particular taxpayer. The determination of fair market value can be divided into two distinct inquiries. First, is fair market value the amount it would cost a similarly situated taxpayer to purchase the property—the so-called "replacement value"—or the amount that the taxpayer would realize on the sale of such property—the so-called "liquidation value"? Second, what value should be chosen among the range of prices available under the appropriate standard, whether liquidation or replacement value?

In general, the courts have used replacement value as the proper measure of fair market value. Although both the courts and the Internal Revenue Service have departed at times from the replacement value rule, and have adopted liquidation value as the appropriate measure of fair market value, they have not articulated a consistent theory for justifying this departure. Thus, there is little guidance for determining fair market value in the tax law.

This Article sets forth a new approach for determining whether replacement value or liquidation value is the appropriate measure of fair market value. The proposed approach is based on the conclusion that the standard for determining fair market value should not be mechanically applied to all areas of the tax law. This Article sets forth guidelines for a flexible approach to the determination of fair market value. This approach is applied to five areas of taxation: (1) income inclusion, (2) estate and gift valuation, (3) business deductions, (4) loss

8. A new electric corn popper, for example, may not be marketable at retail by an individual because it does not have an unopened container, a condition that does not affect the corn popper itself. Even if the casual seller can meet these threshold market entry barriers, he generally cannot engage in a transaction with a casual purchaser without a substantial amount of effort.


10. See infra text accompanying notes 121-23 (describing liquidation value). See, e.g., Ivan Allen Co. v. United States, 422 U.S. 617, 36 A.F.T.R.2d (P-H) ¶ 75-5073, 75-2 U.S. Tax Cas. (CCH) ¶ 9557 (1975) (value of securities for purposes of determining accumulation beyond the reasonable needs of the business viewed as net realizable value, i.e., liquidation value); Hicks v. United States, 486 F.2d 325, 33 A.F.T.R.2d (P-H) ¶ 147,867, 73-2 U.S. Tax Cas. (CCH) ¶ 12,958 (10th Cir. 1973) (liquidation value rather than book value used to determine real estate holdings of a corporation for estate tax purposes); Forbes v. Hassett, 124 F.2d 925, 28 A.F.T.R. (P-H) 866, 42-2 U.S. Tax Cas. (CCH) ¶ 10,127 (1st Cir. 1942) (stock); Estate of Huntington v. Commissioner, 36 B.T.A. 698 (1937); Estate of Weingarten v. Commissioner, 13 B.T.A. 249 (1928).
valuation, and (5) charitable contribution deductions. The proposed approach is contrasted with that of the IRS in the areas of charitable contributions and valuation abuses. The Article also suggests a method to determine appropriate value once the standard has been chosen, and concludes that the proposed test for determining fair market value is consistent with existing tax principles as well as with the policies underlying the law.

II. A Flexible Approach to Fair Market Valuation

The standard for determining fair market value—whether replacement or liquidation value—should further the purpose of the particular statutory provision that requires the valuation. The standard, therefore, must vary with the purpose underlying the provision under consideration. A flexible definition of fair market value assures that the relevant provisions of the tax law accomplish their objectives.

The proposed approach to fair market valuation is based upon two general principles that look to the ownership of the property at the time of valuation to determine whether replacement value or liquidation value is appropriate:

1. Replacement value is generally the proper method of valuation when the taxpayer (or his estate or beneficiary) retains the property after the transaction that gives rise to the need for valuation.
2. Liquidation value is the proper measure of valuation when the taxpayer (or his estate or beneficiary) does not retain the property.

These principles are derived by viewing transactions in property as a series of cash transactions. The transfer of property may be characterized in one of two ways: If the taxpayer possesses the property at the conclusion of the transaction, it may be viewed as a transfer of cash followed by a purchase of the property; if the taxpayer does not possess the property, it may be viewed as a sale of the property for cash followed by disposition of the sales proceeds. Under either characterization, the amount of cash that would substitute for the property in the transaction and leave the taxpayer in the same economic position that he is in after the transaction is the measure of fair market value of the property.

The two-transaction approach is supported generally by case law. In United States v. General Shoe Corp., for example, a corporation made a contribution of appreciated realty to an employee's pension
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trust.\textsuperscript{11} The court held that the corporation was entitled to a deduction equal to the fair market value of the property.\textsuperscript{12} The court also found that the corporation had realized taxable gain in the amount of the excess of the fair market value of the realty over its basis.\textsuperscript{13} The corporation was treated as if it had sold the real estate for cash in the amount of its fair market value and contributed the proceeds to the trust.\textsuperscript{14} Several decisions have adopted the arm's length exchange rationale of \textit{General Shoe}.\textsuperscript{15}

The proposed approach results in the application of a variant standard—replacement value or liquidation value—to define the single concept of fair market value. Such a variant definition of terms has substantial precedent in the tax law. \textit{Philadelphia Park Amusement Co. v. United States}\textsuperscript{16} demonstrates that a concept in the Code may be given two separate meanings in order to accomplish the underlying purpose of the section under consideration. In \textit{Philadelphia Park}, the court had to determine the "cost" of property received in exchange for other property in order to determine the basis of the acquired property.\textsuperscript{17} In cash acquisitions, the cost of the property is the amount of cash paid for it.\textsuperscript{18} The court held, however, that the cost of the property acquired in this exchange was its fair market value, rather than the fair market value of the property surrendered.\textsuperscript{19} The court interpreted the tax concept of "cost" in a way that would achieve the purpose of the Code provision.\textsuperscript{20} This approach was necessary to ensure that gain taxed at the time it was realized would not be taxed again.\textsuperscript{21}

A similar interpretation of technical tax concepts that is oriented

\begin{enumerate}
\item \textsuperscript{11} 282 F.2d 9, 6 A.F.T.R.2d (P-H) \textsuperscript{60-5133}, 60-2 U.S. Tax Cas. (CCH) \textsuperscript{9678} (6th Cir. 1960), \textit{cert. denied}, 365 U.S. 843 (1961).
\item \textsuperscript{12} \textit{Id.} at 13, 6 A.F.T.R.2d (P-H) at 5473, 60-2 U.S. Tax Cas. (CCH) at 77,862.
\item \textsuperscript{13} \textit{Id.} at 12, 6 A.F.T.R.2d (P-H) at 5472-73, 60-2 U.S. Tax Cas. (CCH) at 77,861-62.
\item \textsuperscript{14} \textit{Id.} at 11-12, 6 A.F.T.R.2d (P-H) at 5472, 60-2 U.S. Tax Cas. (CCH) at 77,861.
\item \textsuperscript{15} \textit{See, e.g.,} Tasty Baking Co. v. United States, 393 F.2d 992, 994, 21 A.F.T.R.2d (P-H) \textsuperscript{68-538}, at 1284, 68-1 U.S. Tax Cas. (CCH) \textsuperscript{9366}, at 86,975 (\textit{Ct. Cl. 1968}); Withers v. Commissioner, 69 T.C. 900 (1978). \textit{See also} International Freighting Corp., Inc. v. Commissioner, 135 F.2d 310, 313-14, 30 A.F.T.R. (P-H) 1433, 1436, 43-1 U.S. Tax Cas. (CCH) \textsuperscript{9334}, at 9496 (2d Cir. 1943).
\item \textsuperscript{16} 126 F. Supp. 184, 46 A.F.T.R. (P-H) 1293, 54-2 U.S. Tax Cas. (CCH) \textsuperscript{9697} (\textit{Ct. Cl. 1954}).
\item \textsuperscript{17} \textit{Id.} at 187, 46 A.F.T.R. (P-H) at 1296, 54-2 U.S. Tax Cas. (CCH) at 46,910.
\item \textsuperscript{18} \textit{See} I.R.C. \textsuperscript{\$} 1012 (1976).
\item \textsuperscript{19} 126 F. Supp. at 189, 46 A.F.T.R. (P-H) at 1298, 54-2 U.S. Tax Cas. (CCH) at 46,911.
\item \textsuperscript{20} \textit{Id.} at 188, 46 A.F.T.R. (P-H) at 1297, 54-2 U.S. Tax Cas. (CCH) at 46,910-11.
\item \textsuperscript{21} The principle of interpreting terms in accordance with the context in which they appear, even though this may produce several interpretations of a single term, also was accepted by the Supreme Court in \textit{Burnet v. Logan}, 283 U.S. 404, 9 A.F.T.R. (P-H) \textsuperscript{1453}, 2 U.S. Tax Cas. (CCH) \textsuperscript{736} (1931). \textit{Burnet} involved the question of when the value of a promise of future payment could be ascertained in order to determine the tax consequences of its receipt. The Supreme Court required valuation of the promise for purposes of determining the amount included in an estate, but refused to value the promise to compute the amount of income reportable on its receipt.
\end{enumerate}
to the purpose of the provision can be found in the estate tax and charitable contributions contexts. In the estate tax area the phrase “time of [decedent’s] death” has been given different meanings to correspond to the various purposes underlying each Code section. Courts have interpreted the phrase to mean “immediately after the decedent’s death” for purposes of section 2031, and “immediately before the decedent’s death” for purposes of section 2033. In the charitable contribution area, one court has accepted the view that the appropriate measure of valuation can vary with the context in which the valuation issue arises, and that valuation for gift tax purposes can be made according to a standard different from that used for valuation for charitable contribution purposes.

Tax concepts must be interpreted in a flexible manner in order to

Instead, the Court allowed the transaction to remain open so that the taxpayer reported the income as proceeds were received on the promise.

The crux of this decision was the recognition that estate tax collection and income tax collection involve different problems for the government. For estate tax purposes a determination had to be made at the time of the decedent’s death; if the tax were not collected at that time, it would never be collected. For income tax purposes, however, a determination could await further developments. Tax not collected from the seller at the time of the sale could be collected later, when the proceeds of the sale were received. See id. at 413-14, 9 A.F.T.R. (P-H) at 1455, 2 U.S. Tax Cas. (CCH) at 243.

22. Goodman v. Granger, 243 F.2d 264, 51 A.F.T.R. (P-H) ¶ 67, 57-1 U.S. Tax Cas. (CCH) ¶ 11,687 (3d Cir. 1957). The court in Goodman defined time of death as immediately after death for § 2031 valuation purposes, because the tax should measure the value of the assets transferred to beneficiaries by reason of the decedent’s death. Id. at 268-69, 51 A.F.T.R. (P-H) at 72, 57-1 U.S. Tax Cas. (CCH) at 57,687. In that case the executor sought to value the decedent’s right to receive payments for a certain time period, contingent upon his fulfilling his duties and not engaging in a competing business after leaving his employment. These contingencies existed immediately before the decedent’s death. The court, however, held that the value of the rights should not consider the contingencies existing prior to death, because the rights should be valued at the point immediately after the decedent’s life had ended.

23. Connecticut Bank & Trust Co. v. United States, 465 F.2d 760, 30 A.F.T.R.2d (P-H) ¶ 147,694, 72-2 U.S. Tax Cas. (CCH) ¶ 12,875 (2d Cir. 1972). The court in Connecticut Bank interpreted the phrase to mean “immediately before the decedent’s death” for inclusion purposes under § 2033. Therefore, the amounts received under the Connecticut wrongful death statute were not includible in the decedent’s gross estate for federal estate tax purposes because the decedent never had any right to these amounts, which could not pass from him at his death. Under the statute, the decedent could not possess a property interest in the cause of action before his death.

The Internal Revenue Service has accepted the holding of this decision. See Rev. Rul. 75-127, 1975-1 C.B. 297. See also Rev. Rul. 69-8, 1969-1 C.B. 219; Rev. Rul. 68-88, 1968-1 C.B. 397.

24. Tuttle v. United States, 436 F.2d 69, 27 A.F.T.R.2d (P-H) ¶ 71-313, 71-1 U.S. Tax Cas. (CCH) ¶ 9140 (2d Cir. 1970). The court permitted a deduction for a charitable contribution of a life insurance policy in the amount of its liquidation value rather than its replacement value, even though it acknowledged that the replacement value would have been the appropriate measure for gift tax purposes.

Although the court was correct in applying a purpose oriented analysis, its opinion reflects confusion in the rationale. The court apparently considered the subjective value to the donee as an indicia of value for tax purposes. The charitable organization that received the life insurance sold it shortly after receipt, and the court used this liquidation value as the amount of the deduction for the taxpayer. The court noted that if the donee had held the policies for investment, it
advance the legislative objectives underlying the Code provision in question. The mechanical approach that otherwise results gives taxpayers the opportunity to circumvent the purpose of the statute. The approach proposed in this Article creates distinct guidelines, yet it prevents the inadequacies of a single, rigid definition.

III. Application of the Proposed Approach to Fair Market Value Determination

A. Fair Market Valuation of Income

1. Existing State of the Law.—A taxpayer who receives property as an item of income must include its fair market value in his gross income. The objective of this provision is to ensure that a taxpayer who has received an economic benefit pays tax on the resulting enrichment. The fair market value of the property received is the measure of enrichment.

Normally, the replacement value of the property received is the proper measure of enrichment. It accurately measures the value of the acquired property because the taxpayer has avoided payment of that amount by receiving the property in kind. The Treasury Department has adopted the replacement value position in several revenue rulings and in a discussion draft of proposed income tax regulations on fringe benefits. Not all courts, however, have looked to replacement value might have required the use of replacement value as the appropriate means of valuation. Id. at 72, 27 A.F.T.R.2d (P-H) at 71-356, 71-1 U.S. Tax Cas. (CCH) at 85,651.

The court's analysis may be interpreted to mean that one must look to the subjective value of property in determining its fair market value, and that subjective value may differ depending upon whether the case arises in a gift tax, estate tax, or income tax situation. The more probable interpretation, however, limits the opinion to life insurance policies, which, in general, do not have a ready market for sale. The weakness in the court's opinion results from the failure to understand that the difference between replacement value and liquidation value is not a subjective concept depending upon the method of transfer. The difference results because of the market-place circumstances of the donor. Insurance companies sell insurance policies at a price that includes the agent's commission and a reasonable profit. That policy's cash surrender value, on the other hand, represents simply the savings account feature in the life insurance policy—its wholesale value without the insurance company's retail markup. The court should have decided the legal approach for valuing the property without relying on the subjective elements of the transaction, possibly peculiar to life insurance.


27. See Rev. Rul. 80-322, 1980-2 C.B. 36 (fair market value of business suits received by employee includible in income over years for which they were available to him). See also Rev. Rul. 58-347, 1958-2 C.B. 878 (fair market value of prizes awarded on a television show).

as the appropriate measure of the fair market value of property included in income.

Replacement value is generally adopted in cases in which the taxpayer receives either compensation in kind\(^{29}\) or a taxable prize.\(^{30}\) In Ireland v. United States,\(^{31}\) for example, the Fifth Circuit held that a taxpayer using a company airplane for commuting purposes must include the fair market value of the flights in his income.\(^{32}\) The court measured the fair market value of the flights by looking to the cost of comparable charter flights.\(^{33}\) The staff of the Joint Committee on Internal Revenue Taxation reached a similar conclusion in examining former President Nixon's tax returns for the years 1969 through 1972. The staff concluded that the President received income from his family's use of government planes for nonbusiness purposes.\(^{34}\) In valuing those flights, however, the staff used the price of first class commercial flights rather than the price of charter flights, because security precautions, rather than the convenience of the family, necessitated the use of presidential aircraft.\(^{35}\)

Courts have departed from the use of replacement value in the

29. *See, e.g.*, Bardahl Mfg. Corp. v. Commissioner, 19 Tax Ct. Mem. Dec. (CCH) 1245 (1960) (employee had income from the use of a company automobile in the amount of the vehicle's fair rental value rather than merely the car's operating costs to the company, although taxpayer conceded rental value to be equal to the depreciation on the car for one year). *See also, e.g.*, McDonald v. Commissioner, 66 T.C. 223 (1976) (an employee who received housing abroad which did not qualify for exclusion under I.R.C. § 119 must include the fair market value of that lodging in income, even though the accommodations were more expensive than indigenous housing).

30. For example, in Wills v. Commissioner, 411 F.2d 537, 23 A.F.T.R.2d (P-H) ¶ 69-610, 69-1 U.S. Tax Cas. (CCH) ¶ 9401 (1969), Maury Wills received the Hickok belt as a "trophy" for his athletic performance during 1962 and an MG automobile in recognition of his being the most popular Los Angeles Dodger that year. Without discussing whether the fair market value of these items was less than their retail value, the court held that Wills had to include in his income the fair market value of the items. *Id.* at 543, 23 A.F.T.R.2d (P-H) at 69-1520, 69-1 U.S. Tax Cas. (CCH) at 84,644.

Similarly, in Hornung v. Commissioner, 47 T.C. 428 (1967), the court required the taxpayer to include the fair market value of a Corvette received as a prize during the year. In both of these cases the taxpayers retained and used the prize received. Accordingly, it seems justified that the retail value of the prize should be included in taxpayer's income.

31. 621 F.2d 731, 46 A.F.T.R.2d (P-H) ¶ 80-5118, 80-2 U.S. Tax Cas. (CCH) ¶ 9556 (5th Cir. 1980).

32. *Id.* at 736-37, 46 A.F.T.R.2d (P-H) at 80-5390 to -5391, 80-2 U.S. Tax Cas. (CCH) at 84,813-14.

The court agreed with the government that the fair market value of obtaining similar services on facilities in an arm's-length transaction in an open market was the proper standard for measuring income inclusion. The government, however, in its argument attempted to measure the amount of inclusion by looking to the allocated cost of providing flights. *Id.* at 737, 46 A.F.T.R.2d (P-H) at 80-5390, 80-2 U.S. Tax Cas. (CCH) at 84,814.

33. *Id.* at 739, 46 A.F.T.R.2d (P-H) at 80-5393, 80-2 U.S. Tax Cas. (CCH) at 84,815.


35. *Id.* at 161-62.
calculation of fair market value when it would have resulted in an inaccurate measure of enrichment and, therefore, in unfairness to the recipient of the property. In McCoy v. Commissioner, for example, a taxpayer received a new Lincoln automobile from his employer and exchanged the car with a dealer for a new Ford station wagon and $1,000 in cash. The court found that the taxpayer realized income in the amount for which he could have sold the car, rather than its retail price (replacement value). The court's approach, though clouded by a confusing opinion, apparently measured the amount of enrichment received by the taxpayer. The measure used by the court, the liquidation value, accurately reflected the enrichment of a taxpayer who disposed of the property soon after its original receipt.

Similarly, in Turner v. Commissioner, the taxpayers received two first-class steamship tickets from New York to Buenos Aires as a prize in a contest. The taxpayers exchanged the tickets for four roundtrip tourist steamship tickets between New York and Rio de Janeiro. The Tax Court held that the taxpayers did not have to include the $2,220 value of the tickets they won. Instead, they could include a lesser amount ($1,400) that reflected the reduced value of the tickets to the taxpayers in their particular circumstances. Thus, by looking to the actual enrichment of the taxpayer, the court adopted a practical approach to determine the income to be included.

The courts in McCoy and Turner believed that replacement value did not accurately measure the taxpayer's enrichment. In McCoy, the court measured the inequity objectively by looking to the disposition of the property. The liquidation price of the car accurately measured the amount of the taxpayer's enrichment. Accordingly, liquidation value was the proper measure of his income. The Turner court, on the other
hand, sought to correct a perceived inequity, although it did so without objective support for the determination of the taxpayer's enrichment. The taxpayers actually retained their prize, albeit in a slightly altered form. Turner and McCoy represent instances of a court's wrestling with the problems and injustices that result from strict application of a replacement value rule.

2. Application of the Proposed Approach.—The variant valuation approach advocated in this Article leads to the conclusion that for income inclusion purposes, fair market value generally should be measured by replacement value rather than liquidation value. The analysis views a transaction involving property as a two-payment transaction. A taxpayer who has received property as compensation should be regarded as having received cash, and then he should be viewed as having engaged in a second transaction in which he “purchased” the property actually acquired for the cash he was deemed to have received. This hypothetical cash transaction provides the correct measure of income, since an amount of cash equal to the replacement value of the property actually acquired would have been required to purchase the property. In other words, that amount of cash, equal to the replacement value of the acquired property, is the proper measure of enrichment for the receipt of property. Similarly, replacement value generally provides the proper measure of enrichment for the receipt of services.

The replacement value rule in this situation prevents the economic distortion that would result from taxpayers bargaining for compensation in kind rather than in cash. Any rule including property or services in income at less than replacement value would encourage taxpayers to bargain for payment in goods or services, thereby reducing their tax liability without reducing their accretion in wealth. Such bargaining would skew production towards the goods and services most amenable to such use, thereby distorting both production and consumption. A tax system should be neutral with regard to economic choices unless Congress uses the system to create specific incentives.41

A replacement value rule will also prevent inequity among taxpayers. A taxpayer whose employer has access to goods or services at discount prices, for example, can obtain wealth or enjoy personal consumption with a lesser tax burden than another taxpayer working for an employer without such access. Other rules of valuation would

41. See generally S. SURREY, PATHWAYS TO TAX REFORM 126-74 (1973) (discussing tax incentives as a device for implementing government policy).
create horizontal inequity and unfairness by imposing an unequal tax on individuals with equal amounts of economic income.

In a majority of the cases, the replacement value rule will not cause inequity, because the taxpayer has made a voluntary decision to receive the property or services. In some situations, however, the recipient has not been given a voluntary choice between property and cash and must either accept the property or forego all or a substantial part of his income. Theoretically, the taxpayer in this situation has not been enriched by the full amount of the replacement value, because his wealth (as he would measure it in money) has not increased by that full amount. The facts in Turner demonstrate the inequity of the replacement value rule in situations in which taxpayers have not made a voluntary choice to receive the property. Nevertheless, Turner's purely subjective approach is not an acceptable solution.

The weakness of the subjective approach to determining fair market value is that it permits taxpayers to assert false claims of devalued enrichment. The integrity of the self-assessment tax system would be weakened by taxpayers undervaluing in-kind income allegedly forced upon them. Subjective valuation would also create a disparity between the payor's deduction and the recipient's income. An employer, for example, could compensate an employee in kind and deduct the cost of the property or services. The employee, in turn, could claim a smaller value, based upon the worth of the property to him, as includable in his income. A totally subjective approach to valuation, therefore, would create an environment conducive to abuse of the valuation rules.

There are, however, situations in which a departure from replacement value can be made without significant risks of abuse. An ideal

42. 13 TAX CT. MEM. DEC. (CCH) at 462-63.
43. In a related area, the Fifth Circuit in Pevsner v. Commissioner, 628 F.2d 467, 46 A.F.T.R. 2d (P-H) ¶ 80-5288, 80-2 U.S. Tax Cas. (CCH) ¶ 9732 (5th Cir. 1980), rejected a claimed business deduction for expenses for clothes suitable for general wear but not in the particular taxpayer's lifestyle. The court adopted an objective test of deductibility independent of the particular taxpayer's preferences or needs.
44. Furthermore, the same risk is present if nonsubjective liquidation value is used to value the employee's receipt, because the payor will deduct his cost. See text accompanying notes 81-87.

If the employer purchased the item at the replacement value, his business deduction will be his purchase price. If the purchase price was greater than the replacement value because the employer made an unwise purchase, his business deduction should be limited to replacement value with respect to the employee's compensation; but he should be allowed an ordinary loss deduction for the excess of what he paid over the true value. If he purchased the item for less than replacement value, his deduction should be the amount of the replacement value, but he should have ordinary income for the excess of that value over his purchase price. In all cases, payment of a deductible expense with property purchased for that purpose should have the net effect of the cost of the item being fully deductible.
situation for such a departure exists under the facts in *McCoy.*45 Where the taxpayer has sold the property soon after receipt, so that from his point of view the disposition can be viewed as part of the same transaction, the sale proceeds represent an objective standard of enrichment. In the case of a subsequent and immediate sale, the taxpayer shows objectively that the property received was worth less to him than its replacement value. In that event, the property should be valued at the price actually received at its disposition.

This modification to the replacement value rule is consistent with the proposed analysis. A taxpayer who performed services and received payment in property that he then sold without using for personal purposes should be treated as if he had received compensation in cash. The hypothetical cash deemed received by the taxpayer in the first transaction would place him in the same economic position that he ultimately achieves upon completion of the second transaction. The proceeds from his sale of the property establish an objective valuation of his enrichment. Therefore, these proceeds should be the measure of income.46

The adoption of a liquidation value standard in situations in which property received is subsequently disposed of should be analyzed for consistency with existing tax principles. Under this approach, the cash sale proceeds relate back to the original transaction to determine for purposes of income inclusion the fair market value of the property received. This result, however, can be reached if each transaction is viewed independently under existing tax principles. In the first transaction, the property is valued at its replacement value, which is included in taxable income. The amount included in income becomes the basis of the property.47 If the property is sold subsequently for an amount below basis, the disposition results in a loss. This analysis, however, raises two issues regarding the nature of the loss: Is the loss on the sale deductible, and if so, is it a capital or an ordinary loss? Established tax principles should resolve both issues without creating an inconsistency with the liquidation value rule.

In order for a loss resulting from a voluntary transaction to be deductible, it must be viewed as incurred either in the taxpayer's trade

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45. See supra text accompanying notes 36, 37.
46. This approach is less restrictive than that taken in the discussion draft of the proposed fringe benefit regulation, which would adopt a single replacement value standard of valuation for income inclusion purposes. See supra note 28 and accompanying text.
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or business or in a transaction entered into for profit. The requirements of deductibility should be satisfied as long as no personal use has been made of the property. In the situation of an immediate sale, it is likely that the property has not been used for personal purposes; therefore, the loss should be deductible.

The determination of the character of a deductible loss—ordinary or capital—depends on the nature of the property involved in the transaction. For the loss to be characterized as ordinary rather than capital, the property must be viewed as connected with the taxpayer's trade or business. In this situation, two theories may justify ordinary loss characterization. First, property received as compensation may be viewed as bearing an integral relationship to the taxpayer's business of performing services; therefore, the taxpayer's motive in receiving and disposing of the property would be business rather than investment related. Second, the sale of property, although an independent transaction, may be viewed as relating back to the transaction in which the taxpayer received the property, and therefore the gain or loss from the second transaction should take its character from the original transaction. These theories suggest that the loss incurred as a result of the second transaction should be characterized as an ordinary deductible loss. Therefore, the net effect of the receipt transaction and subsequent sale under existing tax principles should be similar to the result reached under the liquidation standard. Accordingly, the variant valuation approach advocated by this Article characterizes fair market value for

49. Compare, e.g., Marx v. Commissioner, 5 T.C. 173, 174 (1945), acq. 1946-1 C.B. 3, and Campbell v. Commissioner, 5 T.C. 272, 274 (1945) (allowed losses on inherited property sold soon after acquisition where there was no post-acquisition personal use of the property), with Horrmann v. Commissioner, 17 T.C. 903, 910 (1951), acq. on other grounds 1952-1 C.B. 2 (disallowed loss because of personal use).
51. The property may be referred to as a Corn Products asset, the sale or exchange of which gives rise to an ordinary gain or loss. See Corn Prod. Ref. v. Commissioner, 350 U.S. 46, 47 A.F.T.R. (P-H) 1789, 55-2 U.S. Tax Cas. (CCH) ¶ 9746 (1955).
52. See Arrowsmith v. Commissioner, 344 U.S. 6, 42 A.F.T.R. (P-H) 649, 52-2 U.S. Tax Cas. (CCH) ¶ 9527 (1952) (Court applied similar rationale to hold that a payment by the transferee of a liquidated corporation on a judgment rendered against that corporation was a capital loss even in the absence of a sale or exchange since the payment related back to the prior liquidation).
53. There exists one possible difference between the result reached under the proposed approach and the hypothetical two-step transaction. Under the proposed approach, the sales proceeds are includible in income in the year the property is received. Under the alternative analysis, however, sales made in subsequent years will create a timing difference. The replacement value of the property is includible in income in the year the property is received, and the loss is deductible only in the year the property is sold.
income inclusion purposes in a manner consistent with established tax principles.

B. Fair Market Valuation in the Estate and Gift Tax Area

1. The Existing State of the Law.—The estate and gift tax provisions of the Internal Revenue Code are designed to tax the transfer of wealth. The estate tax provisions impose a tax on a decedent’s estate upon transfer of the property at his or her death. The tax is imposed on the value of all property owned by the decedent at his death and certain other property otherwise includible in his estate by virtue of either a prior lifetime transfer or a power of appointment that he had over the disposition of the property.

The Treasury takes the position that property in a decedent’s estate is includible at its replacement value, rather than its liquidation value. Treasury regulations require that the executor value the property at its price in the market in which the item is most commonly sold to the public. An automobile, for example, would be valued at its


55. I.R.C. § 2001 (1976) (providing that “[a] tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States”).

56. See id. §§ 2031-41 (1976). See generally R. STEPHENS, G. MAXFIELD & S. LIND, supra note 54, at 511, ¶ 1.02-1.04[7].

57. For example, the value of a single premium life insurance policy at the date of death is, for estate tax purposes, the amount the insurance company would charge a person the same age as the insured for a single premium contract. See Treas. Reg. ¶ 20.2031-8(a), T.D. 6296, 1958-2 C.B. 432, T.D. 6680, 1963-2 C.B. 417, T.D. 7319, 1974-2 C.B. 297. See also supra note 53 and accompanying text.

58. Treas. Reg. ¶ 20.2031-1(b) (1965) provides as follows:

The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in §§ 20.2031-6 and 20.2031-8. The value is generally
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retail value as a used automobile, rather than at the price for which a dealer would purchase the car from the estate. 59 There are, however, two notable exceptions to the general replacement value rule in the estate tax area: the valuation of tangible personal property sold under certain circumstances and the valuation of corporate stock.

The Internal Revenue Service has adopted a more lenient approach than that suggested in the estate and gift tax regulations in cases in which the property is tangible personal property and is sold through advertisement or auction within a reasonable period after the valuation date. 60 In these situations the Service permits the estate to use the actual sales price rather than the replacement cost as the fair market value. 61 A similar result is accomplished through the estate administration expense deduction when the estate sells property in order to realize cash necessary to pay debts, expenses, and taxes, to discharge legacies, or to preserve the estate. 62 Sales of property for other purposes do not

to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the case of shares of stock or bonds, such unit of property is generally a share of stock or a bond. Livestock, farm machinery, harvested and growing crops must generally be itemized and the value of each item separately returned. Property shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date. All relevant facts and elements of value as of the applicable valuation date... shall be considered in every case. The value of items of property which were held by the decedent for sale in the course of a business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 20.2031-3. See § 20.2031-2 and §§ 20-2031-4 through 20.2031-8 for further information concerning the valuation of other particular kinds of property. For certain circumstances under which the sale of an item of property at a price below its fair market value may result in a deduction for the estate, see paragraph (d)(2) of § 20.2053-3.

This regulation is the authority most often cited as support for the retail value rule. See, e.g., Alma Piston Co. v. Commissioner, 579 F.2d 1000, 42 A.F.T.R.2d (P-H) ¶ 78-5095, 78-2 U.S. Tax Cas. (CCH) ¶ 9591 (6th Cir. 1978).


In Rev. Rul. 55-71, 1955-1 C.B. 110, the Internal Revenue Service carried this approach to an extreme in taking the position that the estate tax value of jewelry not only should reflect the price at which a dealer would sell the property, but also the excise tax that is charged to the buyer in this situation.

60. See Rev. Proc. 65-19, 1965-2 C.B. 1002 (presuming that the actual sales price is the retail sales price).

61. Id.


See Estate of Blossom v. Commissioner, 45 B.T.A. 691 (1941), nonacq. 1966-2 C.B. 7. See also Estate of Papson v. Commissioner, 73 T.C. 290 (1979) (brokerage charge for finding replacement tenant allowed as estate tax deduction because sale of property might have been required to meet estate's obligation to pay estate tax installment payments under § 6166A of the Code).

Several courts have differed on the definition of necessary expenses and on the issue of from whose perspective the necessity is determined. Compare Estate of Park v. Commissioner, 475 F.2d 673, 31 A.F.T.R.2d (P-H) ¶ 147,824, 73-1 U.S. Tax Cas. (CCH) ¶ 12,913 (6th Cir. 1973) (holding that the estate fiduciary's good faith judgment that a sale is in the best interests of the estate, as approved by the state probate court, should be sufficient to establish "necessity"), with Estate of
receive this favorable treatment, however. The increment in the estate's value resulting from property that passes to beneficiaries of the estate or is sold either for nonallowable purposes or in a nonpermissible manner will be its replacement value.

The departure from the strict replacement value rule in estate tax valuation is largely consistent with the McCoy case, the rule's analogue in the income inclusion area, but it falls short of the variant valuation approach proposed by this Article by failing to extend the departure to nonallowable sales. Application of the liquidation value rule in all cases involving sales would provide an objective determination of the amount of wealth transferred by the decedent.

Publicly traded corporate stock represents the second exception to the replacement value standard. Such stock is generally valued at the average high and low selling prices on the date of valuation, without reduction for potential sales commissions in the event of its sale. The value of the stock is not increased by the amount of the sales commission that would have to be paid if the estate had purchased the stock. The rule, therefore, technically fails to conform to either the replacement or the liquidation value standard.

The replacement value versus liquidation value controversy in estate tax litigation has centered around the proper treatment of selling expenses. This issue reached the Supreme Court in the context of valuing open-ended mutual fund shares owned by the decedent at his death.

Smith v. Commissioner, 510 F.2d 479, 35 A.F.T.R.2d (P-H) ¶ 147,972, 75-1 U.S. Tax Cas. (CCH) ¶ 13,046 (2d Cir. 1975), cert. denied, 423 U.S. 827 (1975) (affirming a Tax Court decision that a state probate court finding that a sale is necessary is not determinative of “necessity” for federal income tax purposes).


64. See supra text accompanying note 36.


Under ordinary circumstances, the existence of an organized, well-defined market and the fungibility of the property in question permits the assertion that sales of other shares on the exchange are presumptive evidence of the price that could be obtained for a particular stock. See, e.g., Amerada Hess Corp. v. Commissioner, 517 F.2d 75, 35 A.F.T.R.2d (P-H) ¶ 75-702, 75-1 U.S. Tax Cas. (CCH) ¶ 9480 (3d Cir. 1975); Estate of Damon v. Commissioner, 49 T.C. 108 (1967); Estate of Wright v. Commissioner, 43 B.T.A. 551 (1941).

death. In *United States v. Cartwright*, the Court faced the problem of valuing shares that had no public market. The Court could have valued the shares at the price at which they were sold by the mutual fund to the general public—replacement value—or at the price at which a shareholder could redeem his shares in the fund—liquidation value.

The mutual fund shares were not publicly traded; therefore, the general public could purchase shares directly from the fund only at the so-called “asked” price. The asked price represented the portion of the net asset value of the fund allocable to the share, plus a “load” charge. The load charge represented the sales commission paid to fund underwriters as compensation for selling the fund shares. Mutual fund share owners, however, could redeem their shares in the fund only at the so-called “bid” price. The fund stood ready to repurchase any shares from a shareholder at a price equal to the portion of the net asset value of the entire fund allocable to the redeemed shares. Thus, the bid price, in essence, was the liquidation value of the shares, and the asked price, which exceeded the bid price by exactly the amount of the load, was the replacement value of the shares.

The Internal Revenue Service, relying on a regulation that it subsequently withdrew, argued for replacement value. The Service contended that willing buyers would pay the asked price and that the fund was a willing seller. If mutual fund shares were viewed in the same way as property such as life insurance, then its replacement value would necessarily include the various expenses associated with offering the property for sale at the retail value.

The estate argued for the liquidation value, analogizing the fund shares to ordinary publicly traded corporate stock. Corporate stock is includible in a decedent’s estate only in the amount that would be realized if the shares were sold. This amount is neither increased by the

68. *Id.* at 549, 31 A.F.T.R.2d (P-H) at 73-1462, 73-1 U.S. Tax Cas. (CCH) at 81,310.
69. *Id.* at 547, 31 A.F.T.R.2d (P-H) at 73-1461, 73-1 U.S. Tax Cas. (CCH) at 81,310.
71. 411 U.S. at 551-52, 31 A.F.T.R.2d (P-H) at 73-1463 to -1464, 73-1 U.S. Tax Cas. (CCH) at 81,311-12.
73. 411 U.S. at 551, 31 A.F.T.R.2d (P-H) at 73-1464, 73-1 U.S. Tax Cas. (CCH) at 81,312 (The Court noted that this argument “has the clear ring of common sense to it.”).
74. *See supra* notes 54-55 and accompanying text.
broker's commission paid upon acquisition of new shares, nor decreased by the sales commission normally paid upon disposition of the shares. The Supreme Court found the regulation invalid 75 and held for the estate, including only the liquidation value of the shares in the estate computation. 76

The Cartwright opinion failed to address the legal issue of whether replacement value or liquidation value was the proper measure for estate tax inclusion. The Court focused on the brokerage charge for purchasing the shares and compared this charge to a broker’s commission on the sale of ordinary corporate stock. Thus, the Court seemed to decide only that a separately stated sales commission or any similar charge, like a load charge, should be excluded for purposes of determining the value of the decedent’s property included in the estate. 77

The Court should have recognized the larger issue and squarely decided the proper method of valuation for estate tax inclusion purposes.

At present, property valuation in the estate tax area is usually determined by its replacement value for inclusion in the decedent’s estate. There is an exception for corporate stock and, perhaps, other property that is purchased with a separately stated sales commission or similar charge. Such property is valued without taking the commission or charge into account. There is also an exception for an immediate arm’s length sale of the property in a permissible manner by the estate, and, in effect, an exception created by means of a deduction for other sales by the estate for certain allowable purposes. 78

2. Application of the Proposed Approach. — Application of the variant valuation approach indicates that, for estate and gift tax purposes, the measure of value of property passed to a beneficiary generally should be replacement value. Under the proposed analysis, the decedent’s property would be treated as if the estate had sold the property for cash and transferred the cash to the beneficiary, who in turn purchased the property. Because the cash hypothetically received by the estate provides the measure of the inclusion and because an amount

75. 411 U.S. at 550, 31 A.F.T.R.2d (P-H) at 73-1465, 73-1 U.S. Tax Cas. (CCH) at 81,313-14.
77. The Court decision is also subject to criticism in its analysis of buy-sell agreements where decedents are not required to sell at a particular price, but this shortcoming is not directly relevant to the issue at hand.
78. See supra notes 45-53 and accompanying text.
of cash equal to the replacement value of the property would have to be transferred to the beneficiary in order for him to have purchased the property, replacement value is the proper measure of estate inclusion. A similar analysis leads to the same result for gift tax purposes.

The replacement value rule conforms to the policy objectives of estate and gift taxation. These provisions are designed to tax the transfer of wealth,79 which is the additional amount of wealth accruing to the beneficiary from the inheritance or gift. The transfer should be measured by the expenditure that the recipient has avoided by receiving the property in kind.

If the estate disposes of the property shortly after the transfer, however, the measure of wealth transferred should be the actual sales proceeds, regardless of the circumstances surrounding the disposition. The sales proceeds—liquidation value—provide an objective means for determining the value of the property. That value is the amount of cash that the transferor would have had to transfer in order to put the transferee in the same economic position as he occupies at the conclusion of the entire transaction.

There is one additional situation in which, ideally, liquidation value should be applied. It is conceivable that a beneficiary, given a choice, would not purchase the property received by bequest or gift. Arguably, in this situation, the equitable measure of value should be the liquidation value. The difficulty with this approach, however, is making the determination whether the beneficiary would have purchased the property. One suspects that the subjectivity of the inquiry would create fraudulent claims if there were a possibility that it would reduce the transfer tax. As in the area of income taxation, it is important that valuation determinations be made on objective bases. One possible solution to this problem would be to apply the liquidation value rule to estate or gift tax valuation if the beneficiary disposed of the property at or soon after its distribution. As a practical matter, most property would be converted into cash prior to the distribution anyway if it were not desired by the beneficiary. Regardless of whether the objective test were extended in this manner, such a test is desirable as a requirement for using liquidation value in order to prevent fraudulent claims of undervalued property.

The variant valuation approach proposed by this Article properly characterizes value for estate and gift tax purposes. In general, replacement value should be used for valuing property included in an estate.

79. See supra note 54 and accompanying text.
If, however, the estate or possibly the recipient disposes of the property, the sales proceeds—liquidation value—should be used to value the property for estate or gift tax purposes. The use of a strict replacement standard would preclude the benefits of a flexible standard for valuation in the estate tax area. 80

C. Fair Market Valuation for Business Deduction Purposes

1. Existing State of the Law.—Generally, a business taxpayer who transfers property to pay for a deductible item, such as in compensation for services, is allowed a deduction for the fair market value of the property. 81 Although no court has articulated an approach to fair market value in this area, an analysis of analogous case law indicates that courts would use replacement value as the measure of the deduction. The replacement value approach follows from an extension of the definition of cost.

Under the Philadelphia Park decision, cost in a noncash transaction is, for purposes of determining basis, the fair market value of property received. 82 The fair market value of property is determined by looking to its value as determined in the income inclusion context. As concluded in Part IIIA of this Article, replacement value is the appropriate measure of value for income inclusion purposes; therefore, replacement value should determine cost as well. Similarly, deductions for depreciation of the property, which in the aggregate will equal the cost of the property, 83 must also be based on the replacement value of the property at the time of its noncash acquisition. 84

The notion of using the value of the property received as the amount of the deduction is referred to as the "value received theory of

80. Although the possibility of an undesired receipt seems more likely with respect to lifetime gifts, the same rule of valuation should apply to gifts and bequests. A different conclusion would allow circumvention of the estate tax through the form of lifetime transfers.
82. See supra note 16.
83. I.R.C. §§ 167, 168 (1976). The Tax Equity and Fiscal Responsibility Act of 1982, H.R. 4961, Pub. L. No. 97-248, § 208(a)(1), 96 Stat. 432 (1982), created an exception to this rule for most property acquired after December 31, 1982, that is subject to the investment tax credit. Generally, in such a case the basis of the acquired property is reduced by 50% of the amount of the credit.
84. If the cost of property is completely deductible in the year of acquisition, the amount of the deduction also should be the replacement value of the property at the time of acquisition.
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deductions." 85 This approach has been applied in the context of interest-free loans, 86 and has been succinctly stated as follows:

[W]henever a noncash economic benefit is received under circumstances making its value an item of gross income, the taxpayer must be treated as if he paid for the benefit. Thus, when a taxpayer receives title to property as compensation or a dividend, he includes the property's fair market value in his income. He is treated as having paid that market value to acquire the property; the amount deemed paid becomes his cost basis in the property. 87

Accordingly, the amount deemed paid for determining a business expense deduction should be the same as if the property were received as income.

2. Application of Proposed Approach.—The variant valuation approach advocated by this Article indicates that, for business expense deduction purposes, value generally should be measured by replacement value. A taxpayer who exchanges property for a deductible expense should be deemed to have sold that property for cash and subsequently to have used the cash to pay for the deductible expense. The hypothetical cash represents the amount of the business expense deduction. This amount is measured by the replacement value of the item obtained in an arm's length transaction in exchange for the property. The deduction, therefore, is the replacement value.

Many barter exchanges take the form of an exchange of property for services. This type of exchange poses a special problem with the value of the consideration received. When the value of the consideration received cannot be determined, it is presumed to be equivalent to the value of the property transferred. 88 Thus, the amount of the deduction ultimately depends upon the value of the property used to pay for the services. Again, the question arises whether replacement or liquidation value is the appropriate measure. The circularity, however, is only apparent. The presumed equivalence theory is grounded on the assumption that in an arm's length transaction, the value of the consideration received by both sides will be equal; that is, willing buyers and

87. See Keller, supra note 85, at 273.
88. United States v. Davis, 370 U.S. 65, 9 A.F.T.R.2d (P-H) ¶ 62-661, 62-1 U.S. Tax Cas. (CCH) ¶ 9509 (1962). Davis involved the transfer of appreciated property by a husband to his wife as part of a property settlement incident to a divorce.

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willing sellers will value them equally. In theory, the hypothetical marketplace must be the same for the service and the product. Since the services are valued at replacement value (the amount one would pay to purchase them in the market), it follows that the property also must be valued at replacement value in that same market. Any other rule would be inconsistent with the underlying presumption of equality.

The variant valuation approach proposed by this Article results in the uniform application of the replacement value rule to the valuation of exchanged property used for business deductions. Although the exchange of services for property poses theoretical problems, the presumption of equal value justifies the replacement value approach in that situation as well.

D. Fair Market Valuation in the Casualty Loss Area

1. Existing State of the Law.—The Internal Revenue Code provides a deduction to a taxpayer who sustains an uncompensated theft or casualty loss of property in an amount equal to the lesser of the taxpayer's basis in or the fair market value of the property. The regulations in this area provide a method of valuation designed to recognize the true loss in value to the taxpayer. Replacement cost, in the case of a total loss, is the amount it would cost the taxpayer to replace the property with property of like kind and equivalent condition. This amount does not represent the full cost of the new item; rather, the cost of new property must be reduced by a depreciation factor for the taxpayer's previous use of the item.

89. Id.

90. The amount of the deduction should be equal to the value of the services purchased with the property. The value of those services is determined under the presumed equivalence theory by the value of the property exchanged for those services. This exchange results in taxable gain to the taxpayer on the exchange of his appreciated property based upon the replacement value of the services received. Since for income inclusion purposes those services are valued at replacement value to the taxpayer, it follows under the presumed equivalence theory that replacement value of the property should be used to measure the amount of the business deduction.

91. I.R.C. § 165(a), (b) (1976). See Helvering v. Owens, 305 U.S. 468, 21 A.F.T.R. (P-H) 1241, 39 U.S. Tax Cas. (CCH) ¶ 9229 (1939). Deductions for losses that are not incurred in a trade or business or in a transaction entered into for profit are allowed under § 165(c)(3) if such losses arise from casualty or theft, but only if and to the extent that the loss exceeds $100 and such excess exceeds 10% of the taxpayer's adjusted gross income. I.R.C. § 165(h) (West Supp. 1982). Section 165(c) was amended in 1982 by the Tax Equity and Fiscal Responsibility Act of 1982, H.R. 4961, Pub. L. No. 97-248, § 203(b), 96 Stat. 422 (1982).


93. See id. at § 1.165-7(a)(2)(ii).
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The regulations provide that the cost of repairs to the property will be regarded as "evidence of loss of value" if four conditions are met:

(a) the repairs are necessary to restore the property to its condition immediately before the casualty,
(b) the amount spent for such repairs is not excessive,
(c) the repairs do not care for more than the damage suffered, and
(d) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.94

The courts have held, on the other hand, that if repairs are not made, estimated repair costs will not be accepted as the proper measure of the deduction.95 Instead, the cases require a determination of fair market value without giving further guidance as to whether replacement value or liquidation value should be used.96

The Internal Revenue Service has not taken a clear position on this issue. In an official publication distributed to the public to assist in the preparation of personal tax returns, the Service defines fair market value as liquidation value—"the price at which you could have sold your property to a willing buyer . . . ."97 The publication provides an example of a chair destroyed by fire giving rise to a loss equal to the price the chair would have brought had the taxpayer tried to sell it immediately before the fire.98 In the same publication, however, the Service authorizes valuation of an automobile at its listed retail value, as set forth in the so-called blue books, adjusted for mileage and condition.99 The trade-in value of the automobile is not to be considered.100

2. Application of Proposed Approach—The variant valuation approach to property losses requires that the fair market value generally should be the liquidation value. Under the two-transaction approach, a taxpayer who sustains a casualty or theft loss of property should be regarded as having sold it for cash and subsequently having lost the

94. Id. (emphasis added).
96. See cases cited supra note 95.
98. Id.
99. Id.
100. Id.
cash received. The hypothetical cash provides the measure of the loss, and that amount is the liquidation value of the property.

The liquidation value standard generally accords with the purpose of the casualty loss provision, which is to allow a deduction to alleviate hardship. Since, as in a sale of the property, the taxpayer no longer has the property after the loss, just as if he had sold it, the unrealized sale proceeds should measure his reduction in wealth.

There are situations, however, in which the transaction should not be regarded as ending with the loss of the cash. When the taxpayer actually replaces or repairs the lost or destroyed property, the amount of the loss is measurable by the cash expended for the replacement property or for repairs. Thus, as long as the replacement property or repaired property can be regarded as similar to the lost or destroyed property, the actual replacement value or repair cost is the appropriate measure of the loss. This approach is a logical extension of that adopted by the regulations with regard to the deductibility of repair cost. It also provides an objective determinant of fair market value. Replacement value, of course, is the amount it would have cost the taxpayer to purchase similar property prior to the casualty, rather than the cost of new property, which would not reflect the depreciation of the old property.

The difficulty with this approach is determining when the replacement property is sufficiently similar to the destroyed property. Old, outdated clothing destroyed in a fire, perhaps, cannot be equated with its new replacement counterpart, even when adjusted for wear. A possible resolution to the problem of determining “similar property” may be found in the provisions permitting deferral of gain on involuntary conversions of property under Code section 1033. This provision allows the deferral of gain realized on the involuntary conversion of property if the taxpayer purchases replacement property “similar or related in service or use to the property so converted.” This standard has been interpreted in the case law and could be used to help determine when a taxpayer should be viewed as having replaced lost

101. See supra note 94 and accompanying text.
103. I.R.C. § 1033 provides:
Nonrecognition of gain.—If the taxpayer during [specified replacement] period . . . for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted . . . at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property . . .
property.\textsuperscript{104}

Although the difference between replacement value and liquidation value is often small, and the deductible loss is limited in any event to the taxpayer's basis in the property,\textsuperscript{105} and no deduction is allowed until the amount of the loss over $100 exceeds the floor of 10\% of adjusted gross income,\textsuperscript{106} the confusion in this area should be resolved nevertheless. The policy considerations underlying casualty deductions require that taxpayers receive equitable and consistent treatment. Furthermore, valuation in the tax law should be made with a rational and consistent approach. The variant valuation approach proposed in this Article not only clarifies fair market valuation for casualty loss deduction purposes but also has bearing on other areas as well.

\section*{E. Fair Market Valuation for Charitable Contributions of Property}

\subsection*{1. Existing State of the Law.—} The Internal Revenue Code allows a taxpayer a deduction for contributions to qualified charities.\textsuperscript{107} Taxpayers can contribute cash or property to qualify for the deduction.\textsuperscript{108} If the taxpayer contributes property to the charity, a deduction is allowed for the fair market value of the donated property at the time of the contribution, subject to several important limitations. The amount of the deduction may vary with the status of the property in the hands of the donor and, in some cases, with the character of the donee and the particular use of the property.\textsuperscript{109}

\textsuperscript{104} See generally B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 44.3.3 (1981) (gain on involuntary conversions of property).

\textsuperscript{105} E.g., I.R.C. § 165(b) (1976).

\textsuperscript{106} I.R.C. § 165(b) (West Supp. 1982). See supra note 91.

\textsuperscript{107} I.R.C. § 170 (1976).

\textsuperscript{108} Id.


With a minor exception created under the Economic Recovery Tax Act of 1981, H.R. 4242, Pub. L. No. 97-34, §§ 121(a), 222(a), 263(a), 95 Stat. 196, 248, 264, the charitable contribution deduction is an itemized deduction and is subject to zero bracket amount limitations. In addition, there are dollar limitations to charitable contribution deductions based upon percentages of a taxpayer's adjusted gross income, the nature of the property, and the use to which the donee organization will put the property.

Moreover, the amount deductible of a charitable contribution of property depends upon whether the sale of the property would give rise to ordinary income, short term capital gain, or long term capital gain. If the sale of the property would give rise to ordinary income or short term capital gain, the property is called "ordinary income property." The deduction allowed for the contribution of ordinary income property is its fair market value reduced by any amount that would be treated as ordinary income or short term capital gain if the property were sold.

On the other hand, if the sale of the property would give rise to long term capital gain the property is called "capital gain property." The deduction allowed for the contribution of capital gain property depends upon the nature of the property and the use to which it will be put by the donee organization. If the property is intangible personal property or real property, a deduction is...
The regulations in this area appear to adopt the rule that the value of the property contributed is measured by its liquidation value. In the case of a contribution of property sold in the course of the taxpayer's business, fair market value is the price the taxpayer would have received had he sold a similar quantity of goods in his customary market. 110

Despite the Treasury regulations, the case law has been quite favorable to donors in permitting a deduction for contributed property equal to its replacement value. Donors generally have been allowed a charitable contribution deduction equal to the amount that they would have paid for the donated property, rather than the amount that they could have realized on its sale.

In Goldman v. Commissioner, 111 for example, the court held that the allowable charitable deduction for a donation of medical journals was the "fair market value computed on the price an ultimate consumer would pay, and that what might be paid by a dealer buying to resell is not proper consideration." 112 Similarly, in Alma Piston Company v. Commissioner, 113 the court allowed the taxpayer to deduct the amount for which the donated machinery could have been sold by a dealer, even though the recipient, the Salvation Army, sold the machinery for a much lower amount. The Alma Piston court cited the Goldman case as authority for applying the replacement value rule 114 and referred to the estate tax regulations, 115 which apply the replacement value rule. It was clear that the court assumed that a single valuation rule was appropriate in all contexts of the tax law. 116

allowable, subject to statutory maximum limitations, in the amount of the fair market value of the property. If the property is tangible personal property, however, the deduction allowed is equal to the fair market value of the property only if the donee organization uses the property in its exempt function. For example, a donation of a work of art to an art museum would be allowable in an amount equal to its fair market value. If the tangible personal property is put to an unrelated use by the donee organization, then the charitable contribution deduction is equal to the fair market value of the property reduced by 40% (26 to 46% in the case of a corporation) of the amount of the gain which would have been long term capital gain if the property had been sold.

112. Id. at 478, 21 A.F.T.R.2d (P-H) at 302, 68-1 U.S. Tax Cas. (CCH) at 86,085.
114. Id. at 490.
116. One commentator has suggested that the Goldman case may be applicable in other areas of the tax law. 15 Fed. Tax Coordinator 2d (Research Inst. of Am.) § K-3325 (5th Observation) (1983). There has been, however, very little analysis concerning the interrelationship of various sections of the Internal Revenue Code with the concept of fair market value.
Fair Market Value in Tax Law

In *Daniel S. McGuire*, the Tax Court applied the same replacement value test to the donation of household furnishings and other consumer goods in excellent condition to a hospital. The hospital subsequently sold these items at an auction for prices substantially below the values used for the charitable deduction. The Service contended that the fair market value of the property was the price received by the hospital at the auction. The taxpayer, on the other hand, contended that the appropriate value was the cost that the taxpayer would have incurred if he had replaced the donated property with new items. The Tax Court viewed fair market value as "the price this property would sell for if sold in the market and under circumstances in which the property of this type and quality would normally be sold," not simply the price that could be obtained at public auction. Under this test, the fair market value of property would be the amount for which a dealer would normally sell the property. This value is essentially the replacement value for the ultimate consumer.

In *Tuttle v. United States*, the Second Circuit limited the deduction for a contribution of a life insurance policy to liquidation value rather than replacement value. The taxpayer in *Tuttle* had contrib-

117. 44 T.C. 801 (1965).
118. Id. at 811 n.7.
119. Id. at 804.
120. Id. at 806.
121. Id. The taxpayer's deductions were based on appraisals of replacement value.
123. 44 T.C. at 810. The court distinguished two of its prior decisions. In Philip Kaplan v. Commissioner, 43 T.C. 663 (1965), the Tax Court had decided a similar case of a charitable donation to the same hospital involved in the *McGuire* case, the donation having been followed by a sale of the donated property at a public auction. The court had held that the appraisal was a sham and of no evidentiary value and that the price brought at the auction sale was the best evidence of the fair market value of the donated property and therefore the measure of that fair market value. A similar result was reached in Maurice L. Rivkin v. Commissioner, 24 TAX CT. MEM. DEC. (CCH) 525 (1965). The court in *McGuire* distinguished those cases by viewing the auction sales price as the "most persuasive evidence of the fair market value of the type of property involved in those cases." 44 T.C. at 812. Neither of those cases, in the court's view, was intended to establish a public auction price as necessarily determinative of fair market value. In essence, *McGuire* is distinguished from the other two cases by the presence of a taxpayer who brought forth additional evidence of fair market value of the donated property, so that the court was not forced to decide between a single appraisal of replacement cost and the price actually brought at auction. The court had a reasonable alternative measure of fair market value.

The dissenting opinions in *McGuire*, not without justification, viewed the majority's discussion as inconsistent with the two prior cases. Placing almost conclusive reliance on actual sales of the donated property indicates the prior courts' view that the willing buyer—willing seller fair market value test should look to a market other than retail. The *McGuire* court, however, sought additional evidence in order to determine the retail value of the donated used property.

125. See supra note 24.
uted a life insurance policy to various charitable organizations in succession. After each contribution, the taxpayer deducted an amount equal to the replacement value of the policy. He then repurchased the policy from the organization at its cash surrender value. The court found the proper measure of the deduction to be the cash surrender value rather than the replacement value of the policy, even though it recognized that the appropriate measure of value for gift tax purposes is the replacement value of the policies.

At one time, the Treasury recognized the replacement value test for charitable contributions. Revenue Ruling 55-138 adopted the position that the fair market value of contributed property was the replacement cost to the donor in his most favorable market. Revenue Ruling 68-69, however, modified the prior ruling by substituting liquidation value for replacement value as the measure of the deduction. The current Service position is unclear. In an official publication distributed to assist the public in the preparation of personal tax returns, the Service suggests replacement value as the appropriate standard for valuing charitable contributions of property.

The liquidation value rule, however, has support in the legislative history of the charitable contribution provisions. The Revenue Act of 1917 created the charitable contribution deduction; however, it was

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126. The taxpayer owned a paid-up policy, subject to an outstanding loan in an amount slightly less than the cash value without reduction for the loan on the policy. The replacement value of the policy represents the amount that the insurance company would charge to issue an identical policy to a person of similar age and health. The cash surrender value of the policy represents the amount the insured would receive if he surrendered the policy. In this case the replacement value exceeded the cash surrender value by more than $3,000.


128. 1968-1 C.B. 80 (permitting business taxpayer to deduct the lowest usual price of contributed inventory).

129. Internal Revenue Service Publication 561, Determining the Value of Donated Property 7 (Revised Nov. 1980), reprinted in 2 IRS PUBLICATIONS (CCH) ¶ 33,901 (1981). In valuing used clothing, for example, the Service recommends using "the price buyers of such used items actually pay in used clothing stores, such as consignment or thrift shops." Id. A similar suggestion is made for automobiles with a reference made to the average dealer sales prices as a starting point for valuation. Id. at 8.

130. Pub. L. No. 254, 40 Stat. 1057 (1918). Section 1201(2) of that Act provided as follows: Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or education purposes, or to societies for the prevention of cruelty to children or animals, no part of the net
not until 1938 that Congress dealt specifically with deductions for contributions of appreciated property. The Revenue Act of 1938\(^{132}\) originally contained a provision limiting the charitable contribution deduction for the donation of appreciated property to the lesser of either the adjusted basis of the property in the hands of the taxpayer or its fair market value. The House Ways and Means Committee report indicated that the bill was designed to eliminate the advantage to a donor who makes contributions in securities or other appreciated property to avoid the tax on the unrealized gain.\(^{133}\) The Senate, however, afraid that such a limitation would hurt educational and charitable institutions by discouraging charitable gifts in kind, eliminated the provision from the House bill.\(^{134}\) In conference, the committee accepted the Senate changes.\(^{135}\)

The legislative history of the charitable contribution deduction, therefore, indicates that from its inception the amount of the deduction for contributions in kind would be the fair market value of the property. The Senate and ultimately the entire Congress rejected the attempt to exclude unrealized appreciation from the deduction; the appreciated value was explicitly approved. It is apparent, though, that the approved deduction was for no more than the amount for which the taxpayer could have sold the property. Therefore, the deduction focused on the liquidation value of the property donated to charity rather than on its replacement value.

The Tax Reform Act of 1969 sought to deal with the inequity of taxpayers deriving greater benefit from donating appreciated property than if they had sold it and kept the cash proceeds. The committee report stated that “in some cases it was possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying tax on the gain, and keeping the income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of 15 per centum of the taxpayer’s taxable net income as computed without the benefit of this paragraph.

The report of the Conference Committee does nothing more than indicate that the Act was intended to create a deduction for individuals contributing to charities up to the limit of 15 per cent of the taxpayer’s taxable income. See J. Seidman, Seidman’s Legislative History of Federal Income Tax Laws 1938-1961, at 999 (1938).

The Revenue Acts of 1918, 1921, 1924, and 1932 tampered with the details of the deduction but left the basic concept unchanged. See id. at 312, 733, 838, 917.

132. Revenue Act of 1938, § 23(o), 52 Stat. 447 (current version at I.R.C. § 23(o) (1954)).

133. H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19-20 (1938). The Committee failed to see any justification in principle for the allowance of the deduction in the amount of unrealized appreciation that had never been included in taxable income.


The amendments to the charitable contribution provision reduced the deduction for donations of ordinary income property and certain types of capital gain property. Congress intended to eliminate the possibility of realizing a greater profit from a charitable gift of appreciated property than from its sale. Nevertheless, this possibility still exists, even in cases of gifts of unappreciated property, if a donor may deduct an amount equal to the replacement value of the property when he would realize only its liquidation value in an arm’s length sale. Therefore, the Joint Committee Staff apparently assumed that the value of the deduction would always equal the amount the taxpayer could realize on the sale of the property. While this analysis of the legislative history of the charitable contribution deduction is by no means conclusive, especially considering that the recent amendments came two years after the Goldman decision, it is instructive in determining how the provision fits into the statutory scheme for computing income. Perhaps the most important point of the legislative history is its indication that Congress thought the deduction should reflect the value of what the donor gives up.

2. Application of the Proposed Approach. —The variant valuation approach requires that for the purpose of determining the charitable contribution deduction, fair market value should be measured by liquidation value. Thus, when a taxpayer donates property to charity, he should be permitted to deduct only the amount that he could have received upon the sale of such property, subject, of course, to statutory limitations. The approach views a donor of property as having first sold the property for cash and then having contributed the cash to charity. The amount that the donor could have realized from the sale of the property, its hypothetical cash value, should represent the measure of the deduction.

Under the proposed approach, liquidation value is the correct standard to measure a charitable contribution deduction. The amount of the deduction, therefore, equals the decrease in the donor’s wealth.


138. See supra note 109.
A taxpayer making a charitable contribution has the choice of giving either cash or property. If he transfers property, his decrease in wealth should be measured by the difference between his wealth had he sold the property and kept the proceeds, and his wealth after making the contribution. This approach limits the taxpayer's deduction to the amount for which he could have sold the donated property.

Courts should apply the liquidation value approach to charitable contributions regardless of the long-established rule that a taxpayer is entitled to a deduction for the unrealized appreciation of donated property.\textsuperscript{139} The two-transaction approach can be applied to determine value without creating taxable gain on the appreciated value. In fact, the court in \textit{Tasty Baking Co. v. United States} pointed out that the two-transaction approach was inappropriate for determining gain on the contribution of appreciated property because the contribution did not involve an exchange. The approach, however, can be used to determine the charitable contribution deduction, since it does not depend on the existence of an exchange. Thus, although the two-transaction approach is consistent with a flexible theory for determining fair market value, it does not have to be applied to determine gain on the transaction.

\section*{F. Application of the Proposed Approach in Order to Prevent Abuse of the Charitable Contribution Deduction}

The Service recently expressed concern that donors are taking larger charitable contribution deductions than allowed by law.\textsuperscript{141} This discrepancy occurs when the deduction is measured by replacement value rather than by liquidation value. Several abusive schemes can create large charitable contribution deductions. If the deduction were measured by the liquidation value of the donated property, none of these schemes would distort charitable contribution deductions. The Service, however, has devised several novel responses to the schemes instead of attacking the source of the problem, which is the use of the replacement value standard.

For example, bulk purchases sometimes afford the taxpayer the opportunity to buy property below retail cost. Under one abusive scheme, the taxpayer subsequently transfers the property on a piece-meal basis to several charities and claims a charitable deduction for the replacement value of each item of property. In Revenue Ruling 79-
the Service analyzed a similar situation in which the taxpayer claimed a charitable contribution deduction for the list price of books even though he had purchased them in bulk at a lower price. The Service denied a deduction for any amount in excess of the purchase price because it viewed the books as ordinary income property. Ordinary income property is property that would not receive favorable capital gain treatment if it were sold at the time of its contribution. Under the charitable contribution provision, the deduction allowed for ordinary income property is its fair market value reduced by the amount of gain that would not have been long-term gain if the property had been sold by the taxpayer at its fair market value.

In Revenue Ruling 79-419, the Service took the position that the determination of whether property contributed to charity constituted ordinary income property should be made as if each contribution were a sale. Under that reasoning, the taxpayer who had never sold a book (and, therefore, for purposes of all other provisions of the Code would not have been a dealer in books) should have been viewed as a dealer for purposes of the charitable contribution provision, at least if the number of individual gifts would have made him a dealer if the gifts had been sales. Essentially, the Service would deny a charitable contribution deduction for the unrealized appreciation in property donated to a charity if the property were “held primarily for gifts to charities.”

143. Id.
144. Id.

Ordinary income property includes property held by a dealer primarily to sell to customers in the ordinary course of the donor’s trade or business.


148. Presumably, if one of the items had been sold and the remaining items given to charity, any gain on the items sold would nevertheless constitute long term capital gain since the Service’s position that the donor is a dealer appears to apply only for purposes of § 170.

The hypothetical dealer position of the Service, supra note 130, as applied to the book purchaser situation in Rev. Rul. 79-419 represented a reversal of a position taken by the Service in a previous technical advice memorandum, Letter Ruling 7901001 (Sept. 15, 1977). In that Technical Advice Memorandum, the Service approved a deduction in the amount of the full fair market value of donated books (library books in that case) even though the books were purchased with the intention of making such a contribution. While the Service did not put forward the theoretical dealer argument, it did reserve the determination of the value of the books.


150. Id. The hypothetical dealer argument of the Service in Rev. Rul. 79-419 was foreshadowed by a Technical Advice Memorandum, Letter Ruling 7849008 (Aug. 30, 1978), in which the Service took the position that a horticulturist who grew plants and donated those plants to charity—but never sold them—was denied a deduction for the contribution of the plants in excess of
If the Service had applied the approach proposed in this Article, the donor's deduction would have been limited to the liquidation value of the donated property. The taxpayer's scheme would have failed unless he had shown that he could have sold the books for more than he had paid for them. This showing would have been difficult to make unless the donor was in fact a dealer in books; and if the taxpayer was a dealer in books, his deduction would have been subject to the ordinary income limitations under the charitable contribution provision.

A second scheme used to distort the charitable contribution deduction involves the purchase of property in bulk, the retention of the property for one year, and its subsequent contribution in bulk to a single charity. Under this plan, the donor seeks a charitable contribution deduction equal to the replacement value of each individual piece of property, as opposed to the lower bulk price. Revenue Ruling 80-233 involved a taxpayer who purchased Bibles for eventual donation to a charity. The Service disallowed the charitable contribution for any amount in excess of the purchase price of each particular Bible. In choosing a test to determine fair market value, the Service ruled that reference must be made to the "most active and comparable market place at the time of the donor's contribution."

The Service viewed the collection of Bibles donated to the charity as essentially a single block of property. Presumably, the taxpayer could have donated the Bibles to the charity one at a time, or to several charities in different quantities, and each donation would have been valued at fair market value, which in turn was probably the replace-

their cost. The Service reasoned that if all of those donations had been sales, the horticulturist would have been held to be a dealer in plants and would not have been entitled to a deduction for the appreciation in value of those plants on a charitable gift.

The Treasury followed this Technical Advice Memorandum by issuing Rev. Rul. 79-256, 1979-2 C.B. 105, which applied the hypothetical dealer argument to two situations, one involving a horticulturist who donated plants to charity and the other involving a casual purchaser of lithographs who donated the prints to various museums.

The hypothetical dealer approach has been criticized by Anthoine. See Anthoine, Deductions for Charitable Contributions of Appreciated Property—The Art World, 35 Tax L. Rev. 239, 262-63 (1980).

152. Id. The donor purchased 500 copies of a single edition of a modern translation of the Bible for a total price of $100x, for which the seller of the Bibles furnished him a statement that the property had a total retail value of $300x. The taxpayer donated the Bibles to a single charity that the seller had suggested. The taxpayer claimed a charitable deduction of $300x.
153. Id. The IRS noted that similar lots of Bibles had been sold to the general public for $100x at around the time of the contribution. The Service used those sales as "the most probative evidence of 'fair market' value."
154. Id. The market place was the one where similar quantities were being sold. Accordingly, the IRS held that the fair market value of the Bibles was $100x.
155. Id.
ment value. At some point, the taxpayer's actions would fall into the category of hypothetical sales under Revenue Ruling 79-419, thereby raising his status to that of a dealer for purposes of the charitable contribution provisions. It appears, however, that a point exists where the number of gifts is so small as to render the Service's dealer argument inapplicable, yet the number of block donations may be small enough so that the value of each would approach the retail value of the Bibles if they were sold individually.

The proposed approach to fair market valuation would prevent this abusive scheme by limiting the deductions to liquidation value. The approach would solve the problem even in situations in which the dealer argument advanced in Revenue Ruling 79-419 would collapse. A donor who is not a dealer in Bibles would almost certainly not be able to demonstrate that he could have sold the Bibles for more than he paid for them.

Finally, a third abusive scheme used by taxpayers to distort the charitable contribution deduction involves the bargain purchase of property that is subsequently donated to charity a year or more after purchase. Revenue Ruling 80-69 involved a taxpayer who purchased an assortment of gems from a promoter at the so-called "wholesale" price. The promoter claimed the gems were actually worth three times the price paid for them. The taxpayer subsequently donated the gems to museums after he had held them for more than a year. The Service ruled that “[t]o determine fair market value, reference [must be] made to the most active marketplace at the time of the donor’s contribution.” The estimate, however, must not be based on some artificially calculated estimate of value, but rather with a view towards the actual marketplace in which the gems change hands. That marketplace was the marketplace where the particular taxpayer purchased the gems from the promoter, and where similarly situated taxpayers purchased similar gems. Therefore, the market value of the gems was their purchase price. If the taxpayer, however, had shown

156. The taxpayer could have broken up the lot of 500 Bibles and donated 100 Bibles to five charities. In that event, the blockage factor on the Bibles would not have had as great an effect, and perhaps the value of five blocks of 100 Bibles would have been greater than one block of 500 Bibles. See infra text accompanying notes 172-76.

157. See supra notes 130, 148-150.

158. Such a donor who is not a dealer would have no distribution chain nor facilities to market the Bibles efficiently and inexpensively.

159. 1980-1 C.B. 55.

160. Id. The IRS took the position that the purported wholesale purchase was not in fact a wholesale purchase since it was generally available to members of the general public.

161. Id.

162. Id.
fair market value in tax law

evidence of retail sales of similar gems at a higher price, the replacement value rule would have supported a deduction based on the higher value.\textsuperscript{163} If the Service had adopted liquidation value instead of replacement value as the measure of the deduction, this scheme would have failed even if comparable retail sales could have been shown. As long as the donor was not a dealer, he probably would have been unable to substantiate a liquidation value higher than his purchase price.

The proposed analysis would defeat all three plans for distorting charitable contribution deductions. All of these schemes depend on the donor’s ability to purchase property at prices below the normal retail price. Under all of the schemes, however, once the property is purchased by the donor, it cannot be sold by him for more than his purchase price. In fact, the donor purchases the property for the express purpose of making a profitable donation to a charity. Solutions to these problems should not rest on the questionable positions advanced by the government, but rather on the recognition that replacement value does not represent the proper measure of value for a charitable contribution of property. The amount of the deduction for a charitable contribution should be the liquidation value of the donated property—the amount for which the donor could have sold it.

Although the liquidation value standard would stop charitable contribution abuses, it would not affect all “favorable purchase” situations.\textsuperscript{164} Taxpayers who make true bargain purchases of property could still obtain the deduction on “unrealized” appreciation. That benefit is inherent in the charitable contribution provision and should not be affected by the definition of “fair market value.”

\begin{flushright}
163. \textit{Id.}
164. In Grossman v. Commissioner, for example, a taxpayer contributed property to charity that he had purchased a short time before at a price lower than the amount for which he could have resold it. 32 Tax Ct. Mem. Dec. (CCH) 1013 (1973). The charity, in fact, sold the property for substantially more than the taxpayer had paid. The court allowed the deduction in the amount claimed by the taxpayer.

The result in Grossman would be unchanged by the proposal advanced in this Article. In Grossman, the donor took advantage of avoiding tax on the value of the property that he could realize on the sale, in excess of its cost, a benefit specifically provided by Congress. Some may argue that this benefit is not justified, but it remains an integral part of the structure of §170, though sharply limited in some circumstances by §170(e) enacted under the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. See supra note 109.

The opinion indicated that Grossman was able to pay a price less than fair market value because he was a trustee, a member of the Grossman family group, “was active in the market for unwanted industrial properties,” 32 Tax Ct. Mem. Dec. (CCH) at 1019, and “the price agreed upon by [him] reflected the desire of the seller to dispose of vacant real estate heavily burdened by local taxes, and accordingly, such price may not have accurately reflected the fair market value of the property at the time.” \textit{Id.} at 1018.
\end{flushright}
III. Defining Replacement Value and Liquidation Value

A. Guidelines for a Definition of Replacement Value

When it is determined that replacement value is the appropriate test for fair market valuation, one must decide how to determine that value. Theoretically, a separate determination should be made for each taxpayer, and that determination should depend on the particular market to which the taxpayer has access for purchasing the property.\(^{165}\)

Such determinations, however, are very difficult to make in the context of property valuation. One taxpayer may have access to the retail market only. A similarly situated taxpayer, however, may have a friend or relative in the business who can obtain the property for less than the retail price. Moreover, retail prices may vary considerably with the location of the purchase. The determination of replacement value, therefore, may present insurmountable administrative problems if the goal is precise, equitable valuations. The traditional test of fair market value refers to generalized willing buyers and willing sellers who deal in an open market. This test seems to reject any subjective determination for individual cases. Yet, there are several types of property for which there is no single market clearing price. This problem can be solved by establishing presumptions for valuation, departure from which should be allowed only in limited circumstances.

A determination of replacement value generally should begin with retail value. Retail value represents the price that a retail dealer would normally charge for similar property.\(^{166}\) The retail price rule should apply to used property as well as to new property. (Used property markets have developed among retailers for many kinds of property.\(^{167}\)) The retail price rule should also apply to the transaction regardless of whether the transferor is a dealer. Retail price should be viewed as the price generally charged to customers by the party from whom the taxpayer receives the property if the property is generally sold by that party in the ordinary course of business. In situations in which the

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165. For example, a taxpayer who receives property as compensation for services should include in income the amount that he would have had to pay for that item in markets to which he had access. Similarly, the estate of a decedent should value property included in the estate at the amount the ultimate beneficiary of the property would pay in the market to which he has access.


167. If the valuation involves a used automobile, for example, its replacement value should be the retail price a dealer would charge for the car. A starting point for determining the price is the National Automobile Dealers Association's Bluebook. The price listed in this manual should be adjusted for the condition of the automobile. See Clemons v. Commissioner, 38 TAX CT. MEM. DEC. (CCH) 1071 (1979). See also Faw v. Commissioner, 41 TAX CT. MEM. DEC. (CCH) 717 (1981) (involving use of the National Automobile Dealers' Association Official Used Car Guide for determination of fair market value).
transferor is not a dealer, a plausible argument can be made for using the price paid by the transferor as long as the property was purchased recently, although some theoretical tidiness would be sacrificed.

Retail price should represent the lowest price at which the item is commercially obtainable by the general public in the geographic area. Variation in prices results in part from the various services offered by retail stores. Department store services may include assistance in selecting the product or model, convenience, delivery, gift wrapping, credit sales, warranties, and even a pleasant atmosphere. None of these services, with the possible exception of warranties, affects the value of the product itself. The difficulty with using the lowest commercial price, however, lies in distinguishing actual market prices from strategically discounted prices.

Valuation of property for which there is no dealer market presents special problems. These items should be valued on the basis of comparable property that has been sold through privately negotiated sales. Real estate, for example, should be valued through comparison with recent sales of similar property. In these transactions, replacement value and liquidation value will differ only in the sales commission generally charged for the transaction. Thus, the commission should be included only for determining replacement value, not liquidation value.

The determination of replacement value generally should follow the lowest commercially available retail price for the property under consideration. Valuation of unique property should track comparable private transactions within a reasonable time period. These general presumptions should exist for all valuation using the replacement value standard unless the taxpayer proves circumstances warrant a different value. 168

168. The Treasury Department during the Carter administration attempted to deal with the valuation problem in the context of fringe benefits in another way. The discussion draft of proposed regulations, see supra note 28, enumerated three objective factors to be used in determining replacement value:

1. Conditions and restrictions placed on the purchase or use of the item.
2. The price charged for the item or its use to customers who are not employees, independent contractors or otherwise providing services to the employer.
3. Whether an equivalent item or its use is ordinarily purchased by the general public on an arm's length basis and, if so, at what price.

Prop. Treas. Reg. § 1.61-20 (discussion draft). The proposed regulations also indicated that those factors were not exclusive.

The examples set forth in the discussion draft generally assume that a retail price will be used for valuation and that that price can be established. The draft then states, however, that such a price would be a "relevant factor" in determining the amount of inclusion resulting from the
B. Guidelines for a Definition of Liquidation Value

When it is determined that liquidation value is the appropriate test for fair market valuation, one faces the problem of measurement once again. Liquidation value should depend on the sales proceeds that a taxpayer could have obtained had he sold the property. The liquidation value of property held by a taxpayer who is not a dealer generally should be based on used property values, since the taxpayer could sell it only in the used property market. This market should be the relevant one regardless of whether the taxpayer had in fact used the property.

A subjective test for determining liquidation value presents all of the administrative problems associated with replacement valuation. Presumptions similar to those proposed for replacement value should be created for determining liquidation value. Property normally sold by retail dealers should have a liquidation value equal to the wholesale price of the property. The wholesale price represents the price normally paid by a dealer who purchases with the intention of selling the property. On the other hand, property generally sold only through negotiated private sales should be valued on the basis of comparable sales. As noted previously, liquidation value and replacement value for unique property will differ only in the amount of the sales commission necessary to complete the transaction. Liquidation value should not include the sales commission.

The determination of liquidation value also involves new considerations. The relevant market, its location, and the comparability of goods, all must be part of the decision. However, the wholesale market value presumption adds objectivity to this subjective valuation where a comparable marketplace exists. The burden of justifying a deviation from the presumption should be placed on the taxpayer, who has access to the information necessary to make a satisfactory valuation.

receipt of the benefit. Id. The draft implicitly recognizes, therefore, that some horse trading over valuation will continue but in all likelihood will involve small amounts.

The discussion draft would also exclude from income certain items, such as employer product discounts under certain circumstances, for reasons of administrative convenience. It is unclear whether the draft would consider the recipient's access to a wholesale market to be a "relevant factor" to be taken into account in determining value. Thus the discussion draft fails to deal completely with the problem of valuation.

169. As a result of the limitations imposed on charitable contribution deductions under the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, valuing new property in the hands of a dealer is not a practical problem since dealers would not be entitled to a deduction of the value of the property anyway. See supra note 109.

170. See supra note 123 and accompanying text.

171. See supra note 122 and accompanying text.
C. Addressing the Problem of Blockage

One issue frequently arising with respect to valuation is the concept of blockage—valuation of a large number of units of a particular item that may decrease the per unit value of the property.\textsuperscript{172} The blockage phenomenon occurs because the market for certain property becomes depressed if the full number of units is placed on the market.\textsuperscript{173} Estate and gift tax regulations permit consideration of the blockage effect for valuation purposes and provide in part:

In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.\textsuperscript{174}

Blockage has generally been viewed as arising from the seller's difficulty in disposing of all of the units at the per unit market price. Blockage, however, need not be viewed in terms of liquidation value but rather may be viewed in terms of replacement value as well. If all of the seller's units are placed on the market at one time, a purchaser may end up paying less than the normal per unit market price because of the excess supply of units.

A closely related issue to blockage is control premium for corporate stock. The regulations provide that "the degree of control of the business represented by the block of stock to be valued" is a relevant factor in valuation.\textsuperscript{175} A block of stock representing fifty-five percent of the outstanding stock of a corporation, for example, may be worth more than twice as much as a block representing 27.5 percent because

\textsuperscript{172} See generally Barrett, \textit{Valuation of Stocks by the Blockage Rule}, 29 \textit{Taxes} 465 (1951); Holzman, \textit{The "Blockage" Rule}, 46 \textit{Taxes} 292 (1968); Peters, \textit{Fair Market Value of Blocks of Stock}, 17 \textit{Taxes} 17 (1939). \textit{See also} Watts, \textit{supra} note 65, at 68-97.

the larger block may represent a controlling interest in the corporation whereas the smaller block may not.

The real issue in the blockage and control premium concepts is whether each unit should be viewed as a separate piece of property to be valued individually, or whether multiple units of the same type of property should be viewed in the aggregate as a single item of property. Corporate stock generally should be valued in blocks, as a single item of property representing a percentage share of ownership of the entire corporation. Similar principles should be applied to sufficiently similar items of tangible personal property so that the appropriate discount is made for blockage. Although an exhaustive treatment of this issue is beyond the scope of this Article, it appears that the problems of blockage and control premium are best solved by approaching them as problems of valuing a single item of unique property rather than multiple items.

IV. Conclusion

This Article proposes that the determination of fair market value should depend upon the context of the transaction in which the determination is made. The variant valuation approach is based upon two general principles that look to the ownership of the property at the time of valuation to determine whether replacement value or liquidation value should be utilized in the ultimate determination:

(1) Replacement value is generally the proper method of valuation when the taxpayer (or his estate or beneficiary) retains the property after the transaction that gives rise to the need for valuation.

(2) Liquidation value is the proper measure of valuation when the taxpayer (or his estate or beneficiary) does not retain the property.

176. Recent litigation in this area has centered upon the situation in which a decedent owns one portion of the controlling stock and a related party owns the other, where neither party alone owned a controlling interest. The Fifth Circuit in Estate of Bright v. United States, 658 F.2d 999, 48 A.F.T.R.2d (P-H) ¶ 148,487, 81-2 U.S. Tax Cas. (CCH) (5th Cir., 1981), ¶ 13,436 aff'g the trial court and vacating panel decision, 619 F.2d 407, 46 A.F.T.R.2d (P-H) ¶ 148,407, 80-2 U.S. Tax Cas. (CCH) ¶ 13,359 (5th Cir. 1980), held that valuation of the 27.5% block must be made without taking into account the 27.5% block owned by related parties that, together with decedent's shares, would constitute control. Similarly, the Tax Court in Estate of Lee v. Commissioner, 69 T.C. 860, 874 (1978), non acq. 1980-1 C.B. 3, viewed stock owned by a decedent, which was part of a controlling interest owned by both her and her husband as community property, as a minority interest, and gave no effect to its constituting, together with stock owned by the husband, part of a controlling interest. See also Popstra v. United States, — F.2d —, 50 A.F.T.R.2d (P-H) ¶ 148,213 (9th Cir. 1982); Sundquist v. United States, 34 A.F.T.R.2d (P-H) ¶ 74-6337, 74-2 U.S. Tax. Cas. (CCH) ¶ 13,035 (E.D. Wash. 1974), supplemental opinion disposing of other issues, 35 A.F.T.R.2d (P-H) ¶ 147,976 (E.D. Wash. 1975) (cited by the Tax Court in Estate of Lee).
Fair Market Value in Tax Law

The application of this test to a series of hypothetical cash transactions shows that for purposes of income tax inclusion, business deductions, and estate and gift taxation, fair market value generally should be defined as replacement value. For purposes of casualty losses and charitable contribution deductions, on the other hand, fair market value generally should be defined as liquidation value.

In 1981, Congress enacted section 6659, which provides a new penalty for income tax “valuation overstatements.”177 The penalty may be imposed in cases in which the taxpayer claims a value of property that is 150% or more of its correct amount on a tax return.178 Although there are several exceptions to the overvaluation penalty,179 the new provision is designed to dissuade aggressive taxpayers from overstating the value of property. It provides a risk greater than mere disallowance of that portion of the deduction attributable to the overvaluation.180

Since penalties, unlike interest on unpaid taxes, are not deductible,181 the in terrorem effect of section 6659 may be quite substantial. In practice, however, the penalty may very well be waived in all but the most egregious cases because the taxpayer can avoid the penalty if he has a reasonable basis for the valuation.182 Although the new section changes the risks involved in valuation for the purposes of a deduction, the underlying legal issue remains unresolved.

Nevertheless, the variant valuation approach, coupled with the new penalty, provides the Service with a powerful weapon, particularly against charitable contribution abuse. It creates also a substantial disincentive to overvaluation through the replacement value standard.

The variant valuation approach to determining fair market value provides rules largely consistent with existing tax law. Courts should adopt the proposed approach because it furthers the policies underlying each area of the tax law. Application of the proposed approach provides a consistent and equitable approach to fair market valuation for all taxpayers.

182. The statute itself grants the Internal Revenue Service discretionary power to waive the penalty in such situations. I.R.C. § 6659(e) (West Supp. V 1981).