

Fair Market Value — According to Whom?

Anytime you transfer assets to a person other than your spouse (if he or she is a U.S. citizen), you need to disclose to the IRS the transaction and the value of the assets transferred. If you don't, under current law there will be no statute of limitations for the gift, and the IRS could later call on you to account for gift taxes plus interest and penalties. Determining the value of a gift is simple if you transfer cash but can be more difficult if you transfer other assets. Why? Because you need to determine the gifted assets' "fair market value."

Following the "Fair Formula"

What is the formula to determine fair market value, what does it involve and who determines it? The generally accepted definition of fair market value is "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."

The hypothetical fair market value must take place in the marketplace. This generally will be where the property being valued is most likely to be offered for sale to the public.

This usually will be the retail market and not the wholesale market.

To understand and work within this definition of fair market value, the elements of the definition need to be considered:

The hypothetical sale price. Generally, the sale is presumed to be for cash. The hypothetical sale would assume that the buyer is able to borrow the requisite cash to pay the seller. For example, in a home sale, the seller receives cash because the buyer enters into a mortgage arrangement with a lender. Because the seller is deemed to receive cash, the price received by the seller will not need to be adjusted to reflect assumption of any risk or the time value of money and related interest rate.

The hypothetical buyer and seller. For purposes of valuation, the actual seller and buyer are irrelevant since you must look to hypothetical persons. When you are dealing with unique property, this becomes the most difficult part of the hypothetical sale. Could there really be a willing buyer for a 5% interest in a closely held family business or in a family limited partnership? And, could there really be a willing seller when Dad ordinarily would not sell at any price? Nevertheless, we

have to assume the existence of two states of mind: 1) An imagined owner of the property who is a willing seller, and 2) An imagined holder of cash who is a willing buyer.

The lack of compulsion to buy or sell. A foreclosure sale would not be indicative of fair market value because the price would generally be artificially low since the seller is under a compulsion to sell. Accordingly, we have to assume a situation where the seller wants to sell, but not too badly and the buyer wants to buy, but really doesn't have to.

The reasonable knowledge of relevant facts. It is important that you assume that both parties have reasonable knowledge of the property. The appropriate standard of reasonable knowledge is not what is actually known by the seller or by the buyer on the valuation date. Instead, you must consider the facts that are discernible through reasonable investigation on the valuation date.

For example, assume that a painting which was being valued for gift purposes could be a forgery. The fact that the painting is later determined to be authentic is not a factor on the valuation date, but the possibility of it being a forgery is knowledge that both buyer and seller are assumed to have.

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For federal tax purposes, the definition remains the same for income tax issues as well as estate, gift and generation-skipping transfer tax issues. The definition also applies to transfers both to charity and to family members.

Though you are dealing with hypothetical issues, it is important to be as accurate as possible when determining fair market value. Let us know if we can help with this or any other estate planning concern.