INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Corp A =
Corp B =
Group =

Firm =
Exchange =

State A =
State B =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date =
City =
Industry =

Therapies	=
Therapy 1	=
Therapy 2	=
Therapy 3	=
Therapy 4	=
Technology 1	=
aa	=
bb	=
cc	=
dd	=
ee	=
ff	=
gg	=
jj	=
ll	=
mm	=
nn	=
oo	=
pp	=
qq	=
ss	=
yy	=
zz	=

ISSUE: Whether (1) market capitalization on the change date, (2) market capitalization on the change date taking into account certain exceptional circumstances[1], if any, in the market, or (3) appraised value based on expert opinion, is the appropriate methodology to determine the fair market value of the stock of Taxpayer and its newly acquired subsidiary, Corp B, for purposes of making the I.R.C. § 382 value determination in this case.

CONCLUSION: Market capitalization on the change date taking into account certain exceptional circumstances in the market, if any, is the appropriate methodology to determine the fair market value of the stock of Taxpayer and its newly acquired subsidiary, Corp B, for purposes of making the I.R.C. § 382 value determination in this case.

[1]Both the field and the Taxpayer addressed this issue statement when it originally contained the words “abnormal conditions” and not “exceptional circumstances.” We think that “exceptional circumstances” is a broader and more appropriate phrase for purposes of this case. Moreover, the case law appears to use “exceptional circumstances” and not “abnormal conditions.” Accordingly, we have modified the issue statement by deleting the words “abnormal conditions” and replacing them with the words “exceptional circumstances.”

FACTS:

Taxpayer was incorporated in State A in Year 1, and is based in City, State B. Taxpayer became publicly traded on the Exchange in January of Year 2. Taxpayer is in Industry and engages in research and product development efforts on Therapies based on innovative *aa* modification technologies.

In Year 3, Taxpayer formed a wholly-owned subsidiary, Corp A, which focused on the development of Therapy 4. Corp A completed an initial public offering ("IPO") in Year 5, which resulted in a drop in Taxpayer's stock ownership of Corp A from 100 to *oo* percent. In Year 6, Taxpayer disposed of over *nn* percent of its remaining shares in Corp A.

In Year 4, Taxpayer was engaged in four *bb* development efforts: Therapy 1, Therapy 2, Therapy 3, and Technology 1. All of Taxpayer's *aa* therapy products were in research and development. According to Taxpayer's Form 10-K Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for fiscal year ended December 31 of Year 4, no revenues had been generated from the sale of any of these products, nor were any such revenues expected for at least several years.

On Date of Year 4, Taxpayer acquired all of the stock of Corp B, which had several subsidiaries. At that time, Corp B was engaged in *aa* therapy research and development activities. Immediately before the acquisition, Corp B had three classes of stock outstanding: common stock, series A preferred stock and series B preferred stock. Corp B had *yy* shares of common stock outstanding and Corp B's common shares were publicly traded on the Exchange. Taxpayer acquired Corp B in a transaction that purported to qualify as an I.R.C. § 368(a)(2)(E) tax-free reorganization.

The shareholders of all 3 classes of Corp B stock and the Corp B warrant and option holders received shares of Taxpayer's common stock in exchange for all of their stock and stock rights. Each outstanding share of Corp B common stock was converted into the right to receive *zz s*hares of Taxpayer's common stock. Corp B preferred shareholders and holders of stock rights received Taxpayer's common stock pursuant to a numerical formula set forth in the acquisition agreement. Corp B shareholders and rights holders received a total of *ff* shares of Taxpayer's common stock in exchange for all of their common and preferred shares of Corp B stock as well as all of their Corp B stock rights. After the acquisition, the former Corp B shareholders (both common and preferred shareholders and owners of Corp B stock rights as a group) owned, in the aggregate, less than 50 percent (specifically, *ll* percent) of the total value of Taxpayer's outstanding shares.

On Date of Year 4, Taxpayer's only class of stock outstanding was its common stock. There were approximately *cc* million shares of Taxpayer's common stock issued and outstanding. On that day, Taxpayer's common stock traded at a low of $*qq* and a high of $*dd*, with a mean trading price of $*ss*. Taxpayer's stock trading price closed on the Exchange at a price of $*dd* per share with a trading volume of *ee* shares.

Each share of Taxpayer's stock issued to the former Corp B shareholders and rights holders had the same rights as the existing Taxpayer's common stock trading on the Exchange on Date of Year 4. No new classes of Taxpayer's stock were issued. After Taxpayer acquired Corp B, there were *pp* shares of Taxpayer's common stock issued and outstanding. The corporations began to file consolidated returns with Taxpayer as the common parent of the affiliated group.

Both Taxpayer and Corp B had generated net operating losses, which they carried over to the Group's Year 4 consolidated taxable year and beyond. The Group is a loss group within the meaning of Treas. Reg. § 1.1502-91(c)(1). Corp B's pre-group net operating losses arose in separate return limitation years with respect to the Group.

Taxpayer's acquisition of Corp B resulted in both Taxpayer and Corp B having an "ownership change" under I.R.C. § 382.[2] The Group was required to compute its § 382 limitation for its postacquisition part year and for its subsequent taxable years. To determine the fair market value of the stock of Taxpayer and Corp B for Year 6, a postacquisition year, Taxpayer hired Firm, an accounting company, to perform an analysis of the value of Taxpayer's and Corp B's stock as of Date of Year 4, the ownership change date.

In preparing its Year 6 consolidated return, Taxpayer did not adopt the "market capitalization approach"[3] to determine the fair market value of its and Corp B's outstanding stock on the ownership change date. Taxpayer asserts that the market capitalization approach would have resulted in an inappropriate valuation of Taxpayer's stock because "the market took a considerable period of time to fully comprehend Taxpayer's *aa* therapy and *mm* technologies." Taxpayer also asserts that the market capitalization approach would have resulted in an inappropriate valuation of Corp B's stock because "the market overlooked the value of Corp B's *aa* therapy portfolio and penalized the company for having insufficient cash resources." Instead Taxpayer relied on Firm's appraised value of Taxpayer's and Corp B's stock. Firm adopted the "asset accumulation method"[4] to determine the value of Taxpayer's and Corp B's underlying

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[2] Both the Taxpayer and our Examination Office assert that the Taxpayer had a change of ownership as a result of the acquisition of Corp B. For purposes of this technical advice memorandum, we assume that this characterization is correct.

[3] The "market capitalization approach" (also called the capital market approach) is based on the premise that the value of Taxpayer (or Corp B) for purposes of I.R.C. § 382 can be determined from multiplying Taxpayer's (or Corp B's) mean stock trading price on the change date times the number of shares of Taxpayer's (or Corp B's) stock outstanding.

[4] Under the "asset accumulation method," the value of the corporation is determined by subtracting from the fair market value of all of the company's assets, the fair market

assets on the ownership change date, relying on analyst reports and expert opinions as a basis for its position.

Upon examination of Taxpayer's Year 6 return, the IRS Examination Office rejected Taxpayer's computation of its § 382 limitation for Year 6. Instead, the Examination Office believes that the proper method for measuring the fair market value of shares traded on a stock exchange is the market capitalization approach subject to adjustments to the market price (e.g., for blockage discounts or control premiums) as are warranted by the circumstances. The Examination Office computed Taxpayer's § 382 limitation for its Year 6 taxable year using the market capitalization approach, which approach Taxpayer challenges here. Subsequent to this computation, Taxpayer provided documentation related to Taxpayer's recognized built-in gain on the sale of Corp A's stock in Year 6, which if accepted by the Examination Office, would increase Taxpayer's § 382 limitation for that year.[5]

TAXPAYER'S POSITION:

Taxpayer argues that, in valuing its and Corp B's stock for purposes of determining both corporations' § 382 limit: (1) the asset accumulation method is a more appropriate measure for determining the fair market value of the two corporations than the market capitalization approach; (2) the market capitalization approach is inappropriate here because the market was aberrational on and around the valuation date and therefore market price on the valuation date does not accurately reflect a true fair market value for their stock; (3) the change of ownership date is an inappropriate date on which to measure the value of the two corporations; and (4) if the Service determines that the market capitalization approach is the appropriate measure of value, the resulting market price must be adjusted to reflect a control premium.

Taxpayer asserts that the "asset accumulation method" is a more accurate index of value because exceptional circumstances in the market made the market capitalization approach (i.e., the market price on the valuation date) an inaccurate index of the values of both Taxpayer and Corp B. Taxpayer argues that its and Corp B's stock were severely undervalued on the Exchange on Date of Year 4.

Taxpayer notes that Corp B experienced a decrease in its stock price in the 12-month period prior to its acquisition. According to Taxpayer, in June of Year 3, Corp B had a market capitalization value of over $*gg* million and, as of the beginning of the month which includes Date of Year 4, Corp B's market capitalization had fallen to close to $*nn*

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value of all of the company's liabilities. Estate of Bennett v. Commissioner, T.C. Memo. 1993-34. Taxpayer determined the value of its and Corp B's assets using a discounted cash flow method.

[5] We have not been requested to opine on whether the built-in gain from the sale of Corp A's stock would increase Taxpayer's § 382 limitation for its Year 6 tax year and do not do so herein.

million, a significant drop in stock price. Taxpayer notes that it too experienced a decrease in stock price prior to its acquisition of Corp B. According to Taxpayer, sometime just before Year 4, when Taxpayer announced its intention to acquire Corp B, its market capitalization was close to $*gg* million. In the six months before the closing of the transaction, Taxpayer's market capitalization dropped to under $*jj* million, a significant decrease in its stock price.

Taxpayer supports its assertion that its and Corp B's stock were severely undervalued on the Exchange on the acquisition date with articles out of professional trade journals and opinions of several accounting and valuation experts. Based on these sources, Taxpayer argues that the lack of cash flow, rigorous governmental regulations, multiple clinical trials for each new potential product and new technology platforms not understood by the market resulted in the undervaluation of its and Corp B's stock on the market.

In support of its position, Taxpayer cites the legislative history underlying I.R.C. § 382 (H.R. Rep. Conf. Rep. No. 99-841, at II-187 (1986), *reprinted in* 1986-3 C.B. (vol. 4) 187), PLR 9332004, and a 1992 field service advice (FS-TL-N-6884-92) for the proposition that the market price of stock is not conclusive and that in appropriate cases, fair market value is more accurately determined using valuation methodologies other than market price.

The legislative history underlying I.R.C. § 382 provides, "in determining value, the conferees intend that the price at which a loss corporation stock changes hands in an arms-length transaction would be evidence, but not conclusive evidence, of the value of the stock." H.R. Rep. Conf. Rep. No. 99-841, at II-187 (1986), *reprinted in* 1986-3 C.B. (vol. 4) 187.

Taxpayer focuses on the 1992 FSA, wherein the Service recognized potential litigating hazards in using an unadjusted market capitalization approach in situations where the market bidding and asking prices do not represent the fair market value of the stock. The Service stated,

> Where it is established that such bidding and asking prices do not represent the fair market value of the stock, then a reasonable modification of the value determined on that basis or other relevant facts and elements of value are considered in determining fair market value.

The FSA listed two exceptions to the general rule that price quotations for actively traded stocks are presumptive evidence of fair market value for federal income tax purposes. The two exceptions are: 1) when price quotations reflect [an] overly optimistic or overly pessimistic era; or 2) when the block of stock at issue is actually sold. In the case of an overly optimistic or overly pessimistic era, the FSA raises the issue as to whether the unadjusted market trading prices are fair.

Finally, Taxpayer cites Dellacroce v. Commissioner, 83 T.C. 269 (1984), for the notion that exceptional circumstances relating to the state of the market or the shares being valued can make market quotations unreliable indicators.

PRELIMINARY MATTERS:

First, we note that the field and Taxpayer were unable to reach agreement on a joint statement of facts. The field does not dispute the Taxpayer's statement of facts insofar as it describes the business history and stock trading price history of Taxpayer and Corp B. However, the field notes that certain "facts" that Taxpayer includes in its statement of facts are third-party opinions (such as opinions from analyst reports and reports of investment bankers). The following are some examples of such third party opinions that Taxpayer includes as "facts": Traditional market metrics do not produce accurate valuations for some loss companies and that particular market conditions depressed the stock prices of Taxpayer and Corp B. The investment community does not fully comprehend public information immediately after its disclosure and thus, market prices adjust to this information over longer periods of time. From these third party opinions or "facts," Taxpayer concludes from these "facts" that, in such cases, the market approach to valuation may be considered inappropriate and other valuation methods may be deemed more appropriate.

We include these third party opinions as "facts" in our statement of facts. However, even after our consideration of these facts, we do not agree with Taxpayer's conclusion. We do not find that these facts constitute exceptional circumstances relating to the state of the market, or the securities to be valued, sufficient to compel *discarding* the market price (i.e., the market capitalization approach) as a reliable indicator of fair market value. Accordingly, we have combined the Taxpayer's and the field's statements of fact in our statement of facts above because our analysis and the conclusions as set forth herein would be the same even if we were to address each statement of fact (Taxpayer's and the field's) separately.

LAW AND ANALYSIS:

Section 382 limits the amount of net operating losses that may be utilized following an ownership change. The amount of taxable income of any "new loss corporation" for any "post-change year" that may be offset by "pre-change losses" shall not exceed the "section 382 limitation" for the year. The "new loss corporation" is defined as a corporation which, after an ownership change, is a loss corporation. I.R.C. § 382(k)(3). An "old loss corporation" is a corporation with respect to which there is an ownership change, and which, before the ownership change, was a loss corporation. I.R.C. § 382(k)(2). A "post-change year" is any taxable year ending after the change date. I.R.C. § 382(d)(2). The pre-change loss consists of net operating loss carryforwards of the old loss corporation and net operating losses of the old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period on or before the change date. I.R.C. § 382(d).

The § 382 limitation is equal to the value of the old loss corporation multiplied by the long-term tax-exempt rate. I.R.C. § 382(b). The long-term tax-exempt rate is set by the federal government. The value of the old loss corporation is defined as "the value of the stock of the corporation immediately before the ownership change." I.R.C. § 382(e)(1). The term "value" is defined as "fair market value." I.R.C. §§ 382(e) and (k)(5). The fair market value for the stock is the part of the equation that will limit the amount of pre-change net operating loss taken by the new loss corporation during each post-change year. The regulations promulgated under § 382 do not address the valuation of stock.

1. "Value" of the Stock:

The term "fair market value" used in §§ 382(e) and (k)(5) has a well established meaning that has been universally recognized by the courts. Thus, the fair market value of a share of stock is the price at which the stock "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." Berry Petroleum v. Commissioner, 104 T.C. 584, 637 (1995), citing United States v. Cartwright, 411 U.S. 546, 551 (1973) ([a test] "nearly as old as the federal income, estate, and gift taxes themselves"); Morris v. Commissioner, 70 T.C. 959, 988 (1978).

If a stock is publicly traded on an established market, case law establishes that the stock's trading price is the best evidence of the value of the stock. Amerada Hess Corporation v. Commissioner, 517 F.2d 75, 84 (3rd Cir. 1975); Bankers Trust Co. v. United States, 207 Ct. Cl. 422, 437 (1975); L.B. Maytag v. Commissioner, 187 F.2d 962 (10th Cir. 1951); Hazeltine Corporation v. Commissioner, 89 F.2d 513 (3rd Cir. 1937); Estate of Gilford v. Commissioner, 88 T.C. 38, 55 (1987); Dellacroce, 83 T.C. at 288; Danon v. Commissioner, 49 T.C. 108 (1967); Staley v. Commissioner, 41 B.T.A. 752 (1940); Blumenthal v. Commissioner, 21 B.T.A. 901 (1930); Rev. Rul. 59-60, 1959-1 C.B. 237 ("As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented").

The value of a company is the amount determined by multiplying its trading price per share on the valuation date by the number of shares outstanding. The fair market value per share of stock traded on an established market, including an over-the-counter market, is the mean between the highest and lowest selling prices on the valuation date. See Bankers Trust, 207 Ct. Cl. at 437; Robinson v. Commissioner, 82 T.C. 467, 468 (1984); Meyer v. Commissioner, 46 T.C. 65, 106 (1966), affirmed on this point 383 F.2d 883 (8th Cir. 1967); Batterman v. Commissioner, 142 F.2d 448 (6th Cir. 1944).

A. Exceptional Circumstances:

Notwithstanding the general rule regarding the valuation of publicly traded stock, discussed above, the courts have held that, in appropriate "exceptional circumstances" departure from the trading price is permissible in determining fair market value. See, e.g., Campbell v. United States, 81-2 USTC ¶9676 (Ct. Cl. 1981); Bankers Trust, 207 Ct. Cl. at 437.

Specifically, adjustments to the market price may be made to reflect certain unusual conditions in the market or to reflect discounts or premiums (e.g., blockage, control, etc.) that are warranted by the circumstances. See H.R. Rep. Conf. Rep. No. 99-841, at II-187 (1986). In general, a public market price may not be a reliable indicator of fair market value of a particular block of stock, if the sales made therein are sales of smaller lots than the subject block, forced or coerced sales, sales in a restricted market or if the stock price is considered aberrational on the valuation date. See Amerada Hess, 517 F.2d at 84; Hazeltine Corporation v. Commissioner, 89 F.2d at 519; Heiner v. Crosby, 24 F.2d 191, 193 (3d Cir. 1928), see also, Walter. v. Duffy, 287 F. 41 (3d Cir. 1923) (taxpayer could not use as a comparable sale a forced sale by a bank holding the stock as collateral). Also, the fact that stock is newly issued may be a factor indicating the market price is not an accurate reflection of fair market value. See American Steel Foundries v. United States, 61-1 USTC ¶9374 (Ct. Cl. 1961) (prices paid on the first trades in a green security, newly issued on the exchange and relatively unknown to the investing public, are not as reliable as prices in current tradings in a security well known to the investing public and having an established market); accord, Pope and Talbot, Inc. v. Commissioner, 162 F.3d 1236, 1242 (9th Cir. 1999) (limited partnership interests were newly issued, a circumstance that made the units difficult to value).

The market price may be adjusted to reflect differences between the size of the block of stock being valued and the typical lot size in the market. For example, it is widely accepted that a "premium" may be added for a block of stock carrying with it effective control of a company or additional voting or other rights. Such stock is generally perceived to be more valuable than the shares in the market that lack these features. See Treas. Reg. §§ 20.2031-2(e) and 25.2512-2(e)(last sentence); Amerada Hess, 517 F.2d at 84. On the other hand, if a large block of stock is being valued, the introduction of these shares in the market could have a depressing effect on the market price due to the fact that the market may not be able to absorb such a large supply of stock at any given time, resulting in the supply of the stock exceeding its demand.[6] In such a case, the general market price for the stock is decreased by a "blockage" discount when valuing this block of stock. See Amerada Hess, 517 F.2d at 84; Commissioner v. Shattuck, 97 F.2d 790 (7th Cir. 1938); Estate of Grootemaat v. Commissioner, T.C. Memo. 1979-49.

Generally, even in “exceptional circumstances” the market price will provide the best starting point for valuing securities. Discarding market price for some other method of valuation should occur only where it is clear that adjusting the market price cannot in

[6] Even though the large block being valued may not, in actuality, be introduced into the marketplace, the hypothetical willing seller/willing buyer test assumes a sale in the market.

principle approximate the stock's fair market value. In Amerada Hess, the court opined, "market analysts have developed reliable techniques for determining the amount by which the market price should be adjusted for various abnormalities. Where techniques are relevant, they can be used to adapt the market price so that it sets the fair market value with considerable accuracy." 517 F.2d at 84. Moreover, where there is an established market, market price is generally a more appropriate method of valuing a company than some other method of valuation, such as an asset accumulation approach. In Estate of McKitterick v. Commissioner, the Court stated,

> Formulas and evidence probative of intrinsic value are more appropriate to an unlisted stock valuation, than to the case of a listed stock for which there is an active market demand. . . . It may be assumed that such a discrepancy [between "intrinsic" value and market price] frequently exists, but such a discrepancy does not . . . warrant ignoring the market price as the best evidence of fair market value.

42 B.T.A. 130, 138 (1940). Thus, unless there are exceptional circumstances relating either to the state of the market or the securities to be valued, which *warrant* discarding the market price as a reliable indicator of value, market price should always be the starting point for valuing securities.

Taxpayer argues that the market price is not reflective of the willing buyer-willing seller definition of fair market value enunciated by the courts and Treasury regulations. That definition contains the assumption that the willing buyer and seller both have a "reasonable knowledge of the relevant facts." Taxpayer argues that the market price should be discarded in this instance because the market did not fully comprehend the facts. Paradoxically, Taxpayer also argues that market price should be discarded because the market comprehended other facts all too well. For example, Taxpayer asserts that the market capitalization approach resulted in an incorrect value because "the market took a considerable period of time to fully comprehend Taxpayer's *aa* therapy and *mm* technologies" and "the market overlooked the value of Corp B's *aa* therapy portfolio." At the same time, Taxpayer argues that under the market capitalization approach Corp B's stock is not correctly valued because "the market . . . penalized the company for having insufficient cash resources." For the above and following reasons, we find that market capitalization is the appropriate approach for valuing the stock of Taxpayer and Corp B.

We note that Taxpayer does not suggest the market was deprived of information when it asserts that "the market took a considerable period of time to fully comprehend Taxpayer's *aa* therapy and *mm* technologies" and "the market overlooked the value of Corp B's *aa* therapy portfolio." Instead, Taxpayer appears to be arguing that the market was too slow in comprehending the information it had in its possession. We think, however, that where public markets exist for stock, the market should be considered to have assimilated all available information concerning the company. Estate of Gilford, 88 T.C. at 55. The fact (whether or not supported by third-party opinions) that the market was slow in comprehending information it had in its possession is not an exceptional circumstance warranting adjusting or departing from the market capitalization approach for purposes of I.R.C. § 382. We note that both the United States Court of Claims and the Tax Court have found the market price of a company's stock to be a better indication of the fair market value of that stock than the opinions of analysts and experts as to the value of a company. See Campbell v. United States, 661 F.2d 209, 221 (Ct. Cl. 1981); Frizzelle Farms, Inc. v. Commissioner, 61 T.C. 737, 742-43 (1974).

(i) Aberrational market price:

Taxpayer argues that certain exceptional circumstances exist that justify departing from the market capitalization approach. First, Taxpayer argues that on the valuation date the market price of Taxpayer's and Corp B's stock was an aberration. In support, Taxpayer cites Amerada Hess, where the court stated that "where the stock price on the valuation date is so markedly 'out of line with its price on said exchange throughout the year straddling the critical date' as to be aberrational, another index may be preferable." Amerada Hess, 517 F.2d at 82. Taxpayer asserts that the market price of its and Corp B's stock on the valuation date comes within the standard referenced in Amerada Hess. However, we do not believe that this is the situation presented in the instant case.

We note that the court in Amerada Hess did not elaborate on the specific circumstances in which a "markedly out of line" or aberrational market price might not constitute fair market value. However, the court did indicate that whether the market price is aberrational must be determined based on several factors including the relative market price of the subject stock over the relevant period, the performance of the Industry as a whole and the market as a whole during the period, and existence of any reasons for the high or low market price. The court concluded that the market price on the valuation date was not aberrational, as follows:

> There was, moreover, uncontroverted testimony that the market for White common on October 31, 1960, was not an aberrational one. The expert witnesses who testified on this point viewed the steady decline in the price of the stock after June 23 as part of an overall market downturn occasioned by the poor business climate in 1960 and aggravated by the approach of the Presidential election. N.T. 465; 485. In addition, "White was not having a good year, and they were bringing off a fairly large transaction that year [the Oliver acquisition] which added an element of uncertainty to the situation." N.T. 465. The uncontradicted evidence establishes that the market price on October 31, 1960, was not aberrational, either in terms of a range of contemporaneous quotations on White shares or in terms of the performance of the whole market. The mere fact that the October 31 value was the lowest quoted in 1960 was thus an insufficient basis for rejecting this market price as the fair market value of the stock.

Amerada Hess v. Commissioner, 517 F.2d at 87.

The chart Taxpayer provided in its statement of facts fails to show that the market price for the shares was “aberrational” on the valuation date. Rather, it shows that the combined market capitalization of both companies on the valuation date was the median capitalization for the 6 month period beginning 3 months before the valuation date and ending 3 months after (i.e., , from the beginning of March to the beginning of September of Year 4). Moreover, Taxpayer’s own exhibits indicate that the entire Industry was in a slump. Several of Taxpayer’s own submissions show that the Industry was in a boom phase early in Year 3 but prices “spiral[ed] downward through the early summer until they hit bottom by the end of July [of Year 3]” and “after rising more than 15 percent in the first two months of [Year 4], the Standard and Poor’s [Industry] stock price index has since lagged the broader market, as measured by the S&P 500 index.”

We believe that the Examination Office is in a better position to elicit any additional facts necessary to determine whether Taxpayer’s and Corp B’s stock value as priced on the market on the valuation date was aberrational when viewed: (1) in relation to its market value over a period of several months before and after that date, and (2) when viewed in relation to the rest of the Industry.

(ii) Control Premium:

Taxpayer asserts that the market price of both company’s shares does not reflect a control premium that would be applicable to the blocks of shares at issue. It is recognized that control may confer value. That is, a controlling stock interest in a corporation may be more valuable on a share by share basis than is a minority stock interest that reflects little or no control. Thus, the per-share value of a controlling stock interest in a publicly traded corporation may be greater than the per-share trading price of that stock on the exchange because the type of stock interest routinely traded on a stock market is a minority interest having no control features. The extent, if any, to which control adds value depends on the facts and circumstances of the particular case.

Taxpayer acquired 100 percent of the Corp B stock, which inherently included control of Corp B. Taxpayer paid for all of the Corp B stock using solely its common stock. In this case, applying the long standing willing buyer/willing seller test, Corp B shareholders sold their stock for less than 50 percent of the Taxpayer’s stock. The fair market value of the stock received on the sale reflects the price at which the stock changed hands between a willing buyer and willing seller. Thus, the fair market value of Corp B’s stock, for purposes of determining its § 382(e) value, equals the market price of the noncontrolling block of Taxpayer’s stock (calculated without taking into account a control premium) that the Corp B shareholders received in exchange for their Corp B shares.

The fair market value of Taxpayer's stock for purposes of calculating its § 382 limitation is the value of *all* of its stock, not just the stock issued to the Corp B shareholders. See I.R.C. § 382(e)(1). The Examination Office may wish to consider Taxpayer's claim of entitlement to a control premium as to the value of its own stock. The issue here is: What would a willing buyer pay a willing seller for 100 percent of Taxpayer's stock (which inherently carries with it control)?

The information provided to us suggests that, although Taxpayer was engaged in several *bb* development efforts as of the end of fiscal year ending December 31 of Year 4, Taxpayer had generated no revenues from the sale of any of these products nor did it expect any such revenues for at least several years. If a company is performing poorly, it may be that no prudent investor would pay a control premium for its stock. Nonetheless, for purposes of this technical advice memorandum, we do not opine on this. We leave it to the Examination Office to determine whether the value of Taxpayer's stock should reflect a control premium.

Even if it is determined that a control premium or blockage discount is warranted, it does not mean that the market capitalization approach is abandoned. Control premiums or blockage discounts are applied to the market price. If the Examination Office determines that an adjustment should be made to reflect a control premium or blockage discount, such adjustment should be made to the *market price* of Taxpayer's stock. It is therefore appropriate to first determine the value of such stock based on the market price approach before considering the effect of a premium or discount, if any. See Amerada Hess, 517 F.2d at 84.

(iii) Valuation Date:

Taxpayer asserts that the valuation date should not be the change of ownership date. I.R.C. § 382(e) provides that the value of the loss corporation is the value of the stock of the corporation "*immediately before the ownership change*." Despite this, Taxpayer contends that, assuming arguendo, use of market price is the appropriate methodology, the market price should not be determined as of the date immediately before the ownership change. To support its position, Taxpayer asserts that the market was aberrational because it was fluctuating radically during the period beginning several months before and ending several months after the date Taxpayer acquired Corp B. Therefore, Taxpayer argues that the market price should be determined based on an average for the entire Year 4, rather than as of the single date immediately before the ownership change.

However, the language of the statute is clear. The valuation date as set forth in the statute is the date "immediately before the ownership change." There is no support for Taxpayer's argument that an aberrational market would change the valuation date as set forth in I.R.C. § 382(e).

B. Committee Report, PLR 9332004, and 1992 FSA:

As noted above, in support of its rejection of the market capitalization approach, Taxpayer cites the legislative Committee Report, PLR 9332004, and a 1992 field service advice. We note that none of these sources in any way mandates the rejection of the market capitalization approach in the present situation. Each of these items *expressly support* the application of the market capitalization approach (i.e., the stock's trading price) as the best evidence of the value of the stock. None of these items can be read as support for a position that where an exceptional circumstance exists, the stock market price should be discarded completely in favor of a different valuation approach. Rather, each supports the well established principle that the market price should be the preferred starting point for valuing securities.

Our views are consistent with the language of the Committee Report, which states that the price at which a loss corporation's stock changes hands in an arms-length transaction may not be conclusive evidence of the value of the stock. Even if an exceptional circumstance did exist here,[7] such fact in and of itself is not a sufficient reason to reject the market capitalization approach completely. The existence of an exceptional circumstance may, however, require an adjustment to the market price of the stock. It seems questionable to us, however, that any exceptional circumstance, save perhaps a control premium with regard to Taxpayer's own stock, are presented here.

Finally, we will here comment upon Taxpayer's reliance on the FSA to support its position. First of all, FSAs are not binding on the Service and, in any event, do not provide any support to taxpayers to whom they are not directed. Furthermore, the FSA refers to situations where market price reflects an overly optimistic or overly pessimistic era, as circumstances where market price may not provide the best indication of a corporation's value. We note that this view, while initially endorsed by the 3rd Circuit in Strong v. Rogers, 72 F.2d 455, 457 (3rd Cir. 1934), was later questioned (much more recently) by the same circuit in Amerada Hess. There, the court stated,

> The better view is that the market does provide the best evidence of value, notwithstanding a depressed state, or even a large-scale manipulation, of the market as a whole. Market cycles and susceptibilities are, after all, part of the risk which the trader assumes and which is one of the determinates of value.

517 F.2d at 84. The Amerada Hess Court further noted that its earlier view, as expressed in the Rogers case, was disapproved of by commentators. Here, even if we were to entertain the notion that a possible exception to the use of market price is where the market price reflects an overly optimistic or overly pessimistic era, such is not the

[7] We have not made any determination herein whether any exceptional circumstance justifying departure from the market capitalization approach apply here. This is a determination to be made by the IRS Examination Office.

case here. The Taxpayer has not shown that the market was overly pessimistic and, therefore, a departure from the market price is not warranted.

The FSA's other reference to blockage discount is no more than an acknowledgement of cases that have reduced market price when appropriate to reflect blockage discount, not to substitute a different valuation method entirely.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.