



Considering absorption in equipment values



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The concept of absorption is used relatively often in real estate appraisals and the same concept, known as “blockage,” is well-documented in the art valuation world, particularly in tax-related appraisals.

The term “blockage” — used by the IRS — derives from issues related to selling a large block of stock and seeing the related market decline.

Equipment Auctioneers, whether familiar with the term or not, certainly see the same effect when selling a high volume of similar equipment, such as a fleet of Peterbilt trucks or a yard full of John Deere backhoes. In the equipment appraisal profession, though, absorption is often underused.

Kyle Martin, Supervisory Estate Tax Attorney with the Internal Revenue Service in Oakland, Calif., has stated in public meetings that, in fact, underuse of blockage is one of the more common mistakes he sees in reviewing estate appraisals.

Defining absorption

So, what is absorption, and when is it appropriate to consider absorption in equipment valuation?

Absorption is essentially an effect of the basic economic

law of supply and demand, which states that the greater the supply and the lower the demand, the lower the price will be. Using the concept of absorption in valuing equipment is a way to take into account the length of time needed for the assets to be absorbed by the current market and at a price. The question that needs to be asked, when considering whether absorption is a factor in equipment appraisals, is this: “Are there enough ready and able buyers willing to pay full price if the items were offered for sale at the same time?”

While you may not know the answer to that question, just asking it improves the quality of the equipment appraisal work being done. If you’re not sure, find someone to ask. Your creditable source may be a used equipment dealer, another Auctioneer, or an expert in the particular industry. These are the same folks who can help you formulate your absorption rate calculation. For instance, in a recent equipment appraisal, I was researching values on propane tanks — values that are extremely price/volume sensitive.

Examples

In talking with industry experts, it was determined that if the number of propane tanks in question were released into the used tank market at the same time, the result would be a 50 percent reduction in value. In light of this information, and given the fact that we were opining on the fair market value, we decreased the opinion of value on the tanks by 50 percent to account for the negative effect that would occur



if this volume of tanks were to appear on the market at the same or relatively same time.

In the seminal art tax case in which blockage was first applied as a valuation concept, the agreed upon discount was 37 percent. In perhaps the most famous art valuation tax case — Estate of Georgia T. O’Keefe v. Commissioner — the executors of the estate sought a 75 percent discount in value, arguing that monetizing the estate would “flood the market” and reduce the instant fair market value. The court conceded a 50 percent discount on the collection’s undiscounted valuation of \$36.4 million.

While most equipment appraisers may not be applying discounts to valuations in the millions of dollars, even smaller estates can benefit from the consideration of absorption. In a case involving gift tax, for example, parents were transferring assets of a very large farming operation to their heirs. The operation included 93 tractors and 500 miles of irrigation pipe. After doing the appropriate research, I established absorption discounts for each of these two categories.

When calculating absorption discounts for opinions of values, the critical elements of research are the following:

1. Actual past cases in a related industry (often hard to locate)

2. Creditable, independent industry experts

Support your results

Just as important is the process by which absorption is referenced within the written valuation report. Because absorption is not a commonly used or well understood concept, the narrative report needs to explain clearly and thoroughly why the concept of absorption is being used, how the absorption discount was researched and how it is being applied to the assets being appraised. In addition, be sure that your work file contains all the documentation needed to support your results.

As more equipment appraisers become familiar with and confident in the appropriate and well-researched use of absorption discounts in their valuations, we will be doing our clients,

and the equipment appraisal profession at large, a great service by bringing this valuable and underused tool into wide use. ❖

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