

BUSINESS VALUATION IN A FEDERAL TAX ENVIRONMENT

*techniques to
enhance appraisal
effectiveness*

TIMOTHY K. BRONZA, GERALD P. VALENTINE, AND ROY H. MEYERS

WHEN PREPARING A VALUATION OF A CLOSELY HELD BUSINESS INTEREST, THE APPRAISER SHOULD CONSIDER
CAPITAL MARKET EVIDENCE, QUALITATIVE AND QUANTITATIVE FACTORS, AND VALUATION METHODOLOGY.

VALUATION STRATEGIES 5

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The True Test

of an appraisal opinion comes when that opinion is challenged and subsequently must be defended. The defense of an appraisal opinion may take place in a variety of forums, such as negotiation discussions, administrative proceedings, alternative dispute resolution (ADR), and, of course, before the judiciary. Because the Tax Court deals with valuation issues frequently, it is arguably the most challenging venue in which to defend an opinion of value. The following excerpts, the first two from two recent Tax Court decisions and a third from a highly respected estate planning commentator, support these contentions:

Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million returns are filed each year on which taxpayers report an event involving a valuation-related issue. It is no mystery, therefore, why valuation cases are ubiquitous. Today valuation is a highly sophisticated process. We cannot realistically expect that litigants will be able or want to settle rather than litigate their valuation controversies if the law relating to valuation is vague or unclear. We must provide guidance on the manner in which we resolve valuation issues so as to provide a roadmap by which the Commissioner, taxpayers, and valuation practitioners can comprehend the rules applicable thereto and use these rules to resolve their differences. Clearly articulated rules will also assist appellate courts in their review of our decisions in the event of an appeal.¹

Fomented in significant part by myriad valuation challenges instituted by the IRS over the past decades, a full-fledged profession of business appraisers, such as the

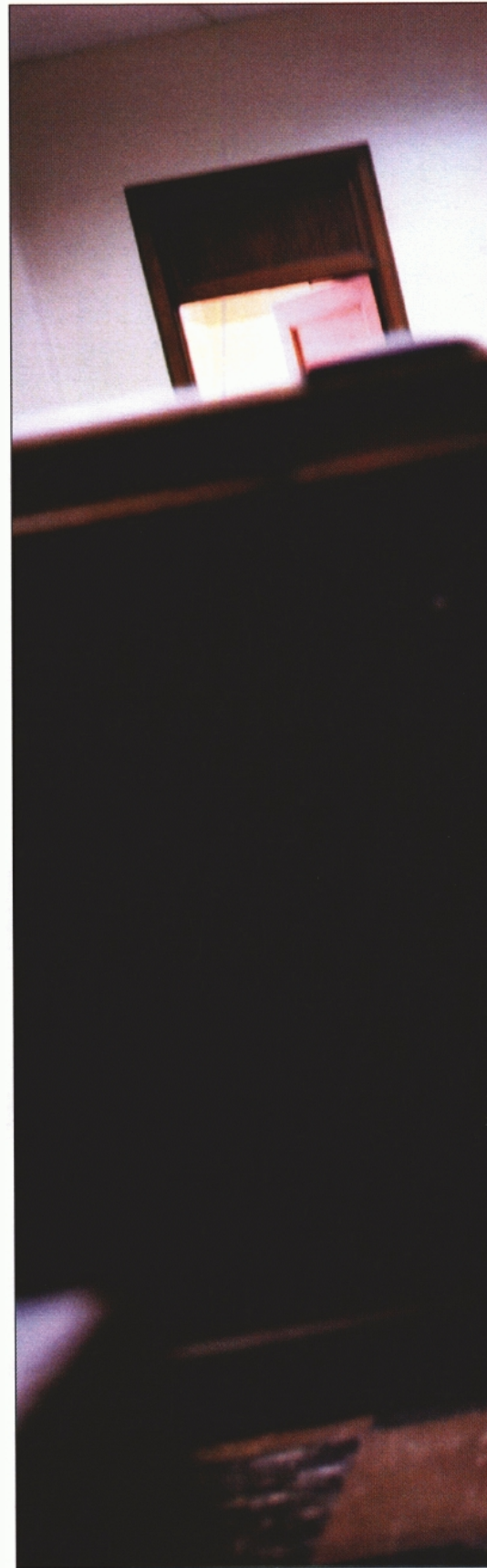
American Society of Appraisers, has emerged, generating its own methodology and lexicon in the process; which in turn have contributed to the profession's respect and mystique. Because—absent an actual purchase and sale—valuing businesses, particularly closely held corporations, is not a pure science replete with precise formulae and susceptible of mechanical calculation but depends instead largely on subjective opinions, the writings and public pronouncements (including expert testimony) of these learned practitioners necessarily contain some vagaries, ambiguities, inexactitudes, caveats, and qualifications. It is not surprising therefore that from time to time disagreements of diametric proportion arise among these practitioners.²

Valuation, already a subject that has generated much estate and gift tax litigation, may continue to be the most hotly contested topic of the new decade. This is an understandable result of a tax that is based on the value of assets that often are nonmarketable and on the value of interests in the enterprises and entities that hold and manage those assets.³

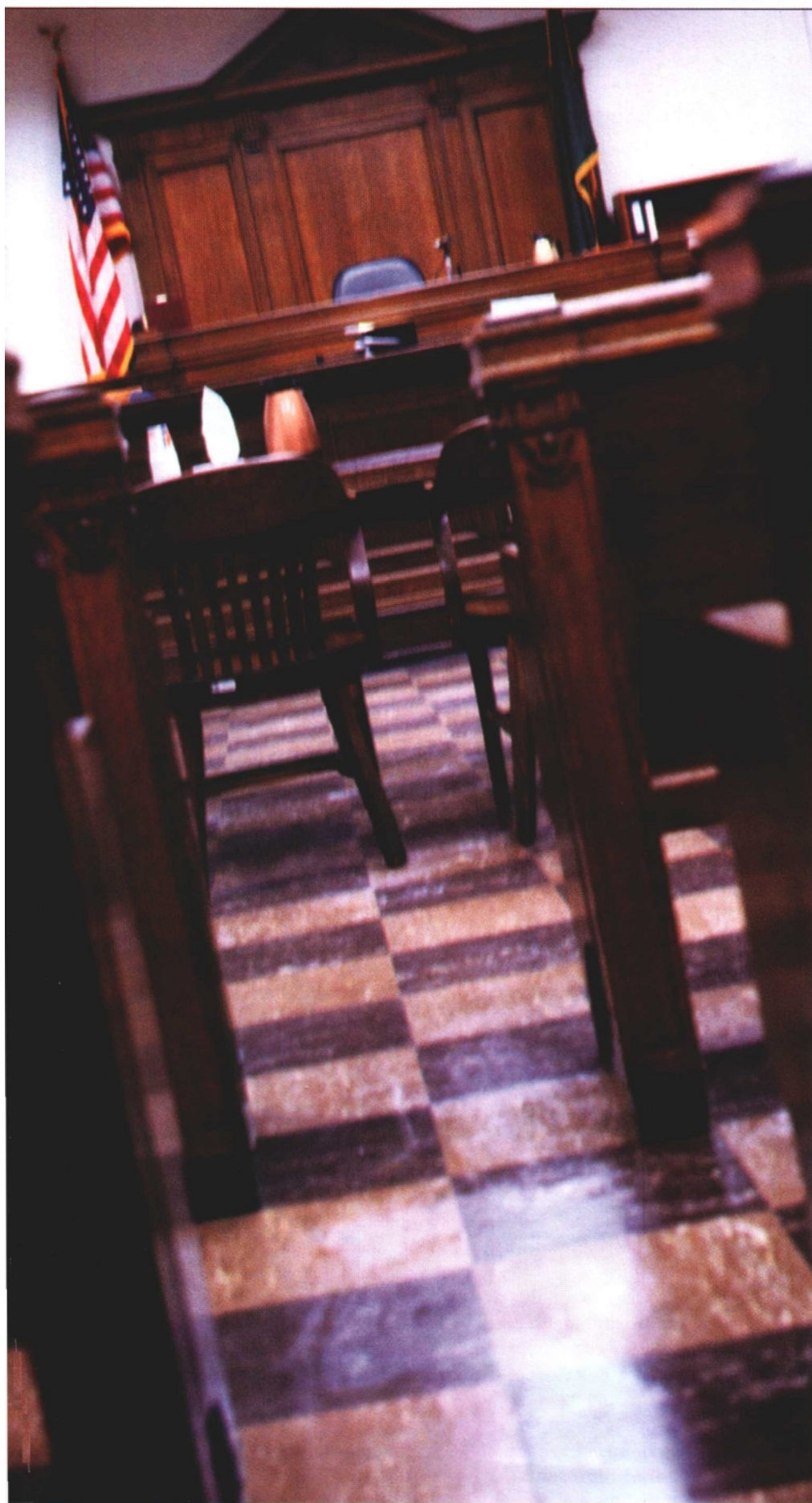
The objective of this article is to present a broad range of business valuation practice concepts designed to enhance the acceptance of an appraisal opinion in a federal estate, gift, or income tax matter before what is often the ultimate arbiter of value, the Tax Court. Because many of the topics discussed will address sound appraisal practice, they are also relevant in IRS administrative proceedings, as well as for appraisal purposes other than federal tax purposes.

The Importance of Capital Market Data

One principle of business valuation practice is incontrovertible: the strength of the appraisal opinion is directly related to the strength of the capital market evidence presented to support the opinion. Certainly, an appraisal opinion is just what it suggests, an opinion. However, the persuasiveness and effectiveness of the opinion is directly related to



TIMOTHY K. BRONZA CPA, ASA, is a Regional Director for Management Planning, Inc. and practices in the firm's Southeast regional office located in Winter Park, Fla. GERALD P. VALENTINE ASA, and ROY H. MEYERS CFA, ASA, are Senior Vice Presidents for Management Planning, Inc. and practice in the firm's Princeton, N.J., corporate headquarters.



the relevant capital market evidence that forms the foundation of the opinion. Thus, the goal of obtaining sufficient and relevant capital market data is to present an optimum level of capital market evidence to form the foundation of the opinion and to minimize subjectivity. Although judgment is inherent in an appraisal opinion, to the extent relevant and sufficient capital market evidence is proffered to support the opinion, the weight of the market evidence will stand largely on its own and yield the strongest opinion of value (presumably leading to acceptance of the opinion). Moreover, Tax Court judges have displayed a propensity to reject appraisal opinions based on weak market data.⁴

In recent years, perhaps due to the expansion of business valuation education, theory, and practice, some commentators believe an observable trend has developed in Tax Court decisions, whereby the side presenting the best appraisal evidence has prevailed. Some observers of valuation decisions rendered by the Tax Court believe this trend commenced with the landmark opinion *Buffalo Tool & Die Mfg., Inc.*⁵ In *Buffalo Tool & Die*, Judge Tannewald said the best appraisal will prevail and the court will no longer split the difference. A number of Tax Court opinions have followed this philosophy, although not as many as one might think. Many factors may be attributable to this deviation from Judge Tannewald's edict. However, reliance on aberrations from the tenets of *Buffalo Tool & Die* may not be advisable. Tax Court judges will likely continue to build on their demonstrated ability to dissect complex valuation issues. Well researched, analyzed, and documented appraisals, incorporating on-point capital market data, will likely prevail.

Investment Holding Entity Valuation

More often than not, investment holding entities, such as limited partnerships, limited liability companies, investment holding corporations, are comprised chiefly of marketable securities or real estate. Accordingly, the bulk of valuation assignments involving non-controlling or minority interest invest-



investments in the securities of these entities will require the use of capital market evidence as to the market price paid for the securities of similar types of entities relative to the market price of the assets less liabilities (or net asset value) of such entities. The use of publicly registered real estate limited partnership (RELP) data as support for quantifying minority interest discounts for real estate holding entities is widely accepted. Similarly, the use of closed-end investment company (CEIC) data as support for quantifying minority interest discounts for investment holding entities funded chiefly with marketable securities is also widely accepted. Both qualitative and quantitative considerations (in absolute terms with regard to the subject entity and relative to the entities on which the capital market evidence of value is based) should be taken into account.

Qualitative Factors. Qualitative considerations may sometimes be overlooked or minimized in the context of valuing an investment holding entity. However, thorough discussion and consideration of the qualitative factors associated with a particular investment holding company set the stage for the quantitative analysis of that entity. In addition, the failure to address the qualitative considerations associated with an investment holding company adequately can be detrimental to the acceptance of the opinion.

Several broad areas of qualitative issues related to the investment holding entity should be addressed to prepare a more robust appraisal. A review of the appropriate legal documents is fundamental to this process. An interview with management or an entity's principals or professional representatives serves to confirm that the entity's man-

agement will be consistent with the intent of the legal document. The management interview also serves to address other factors that could affect value.

The analyst should begin a qualitative analysis by becoming thoroughly acquainted with the rights and benefits associated with the interest being valued. As mentioned earlier, the primary method to acquire this understanding is a rigorous review of the controlling legal documents, such as the corporate articles of incorporation and bylaws, the limited partnership agreement, or the limited liability company operating agreement. Assessment of the controlling legal documents typically involves review of the salient provisions of the legal document. These provisions commonly address the following areas:

- Entity term.
- Business purpose.
- Ownership structure of the entity.
- Entity governance and management privileges and rights.
- Voting privileges.
- Transfer of an interest.
- Profit and loss allocation.
- Cash or dividend distribution.
- Withdrawal.
- Entity dissolution.

It is critical for the analyst to consult with legal counsel as needed in order to have a complete understanding of the key provisions in the legal document.

Additional qualitative subjects worthy of consideration in valuing the investment holding entity are management depth, degree of professional investment management, portfolio asset allocation, and investment objectives. Commonly, closely held investment entities are much smaller than the public entities used for comparison, and their management may be less sophisticated than the management of public analogs. A closely held investment holding entity often does not have full-time investment managers on staff. The portfolio may also be deemed more risky relative to public analogs with respect to diversification (or lack thereof), asset allocation, and investment objectives. These and other qualitative considerations frequently place a closely held investment holding entity at a distinct disadvantage in comparison to a public analog.

Substantiation of a minority interest discount for a real estate investment

holding entity often begins with the selection of appropriate publicly registered RELP data. Frequently, this data is obtained from Partnership Profiles, Inc. and its publication, *The Partnership Spectrum* and are updated periodically throughout the year. This leading publication provides information on RELPs to the investment industry and lists RELPs that have traded in the secondary market, along with their net asset values (NAV) (unit values) and trading (market) prices. The findings of Partnership Profiles' annual studies are published each year in the May/June issue of *The Partnership Spectrum*. Supplementary data regarding the secondary market in RELPs is also provided by Partnership Profiles, Inc. in its *Special Addendum* and *Partner Disc* CD-ROM. These supplementary data resources provide a means for observing factors affecting market value percentages (discounts or premiums of market price relative to NAV) at which the securities of these analog partnerships trade.

The Partnership Profiles study divides partnerships into three main categories: income-producing equity, triple-net-lease, and insured mortgages. The equity partnerships generally own various combinations of the following types of real estate: commercial facilities, apartments, retirement centers, hotels, self-storage/mini-warehouse facilities, manufactured home communities, and retail facilities. The partnerships in the triple-net-lease group generally own properties that are net-leased to tenants pursuant to long-term lease agreements. In contrast to the equity RELPs that actively manage their real estate holdings, triple-net-lease pro-

grams act as landlords only. The insured mortgage partnerships essentially own mortgage loans and/or mortgage-backed securities secured by multi-family apartment complexes, whereby the federal government effectively guarantees payment of principal and interest.

Ideally, the data set for a specific valuation assignment will mirror the type of real estate investment holding entity being valued. The objective is to consider a subset of the Partnership Profiles data that most closely corresponds to the nature of the entity being

RELPs sell include distribution rates of return, earnings rates of return, cash flow rates of return, and leverage ratios. Tables of the raw empirical data and charts presenting this data are excellent tools to present these quantitative factors graphically in the valuation report. (See Exhibits 1 and 2.)

There frequently is an expectation that there will be an inverse relationship between distribution rates of return on NAV and market value percentages of NAV. In other words, the higher the distribution rate a RELP

The Strength of the appraisal opinion is directly related to the strength of the capital market evidence presented to support the opinion.

valued. For example, for a real estate investment holding entity that holds apartment complexes, the RELP data, consisting of equity interests in income-producing properties, might be a broad subset of data. Further reducing this subset to include only those partnerships that invest in apartment complexes would likely be a better scenario, as long as sufficient data exists to make reliable inferences.

Quantitative Factors. Once a sufficient and relevant set of RELPs is selected for use as valuation guidelines, quantitative factors influencing discounts may be addressed. The quantitative factors influencing the market value percentages of NAV at which minority interests in

has relative to NAV, the smaller the expected discount from NAV.

Earnings (and cash flow) rates of return on NAV are generally important to assess when analyzing the value of equity interests, because one aim of investors in a business enterprise is to maximize earnings (and cash flow) on their capital. Similar expectations exist with regard to earnings, cash flow rates of return, and distribution rates of return, i.e., that RELPs with lower earnings and cash flow rates of return on NAV would sell at higher discounts and vice versa. Leverage ratios provide an analytical tool for measuring the effect of debt on discounts from NAV. The general expectation is that RELPs with higher degrees of leverage would sell at higher discounts from NAV and vice versa.

Thorough analysis of the subject entity relative to the capital market data provided by the analog entities, in terms of both qualitative and quantitative factors, should support the appropriate market value percentage of net asset value at which the securities of the appraised entity might trade.

Substantiation of a minority interest discount for an investment holding entity comprised of marketable securities begins with the selection of appropriate publicly traded CEIC's. Frequently, this data is obtained by reference to publica-

¹ Estate of Auker, TCM 1998-185

² Estate of Dunn 301 F.3d 339, 90 AFTR2d 2002-5527 (CA-5, 2002).

³ Aucutt, "Valuation Developments Highlight the Importance of Appraisals," 28 Estate Planning 299 (July 2001)

⁴ See Estate of Berg, TCM 1991-279, *aff'd in part and rev'd on other grounds*, 976 F.2d 1163, 70 AFTR2d 92-6259 (CA 1992)

⁵ 74 TC 441 (1980)

⁶ See Rev. Rul. 59-60, 1959-1 CB 237 and Regs. 20.2031-3(c), 20.2301-2(f)(2), 25.2512-3 and 25.2512-2(f).

⁷ Rev. Rul. 59-60, section 4.01(h), 1959-1 C.B. 237.

⁸ Laro, "Business Valuation: A View from the United States Tax Court", American Society of Appraisers International Appraisal Conference, Denver, Colorado (6/20/95) at 15.

⁹ Wall, TCM 2001-75.

¹⁰ See generally Estate of True, TCM 2001-167 and Wall, note 9, *supra*.

¹¹ For example, see Caracci, 118 TC 379 (2002)

¹² Pratt, Reilly, and Schweih, *Valuing a Business The Analysis and Appraisal of Closely Held Companies*, 3rd ed. (McGraw-Hill, 1996), p. 191.

¹³ Block, "A Study of Financial Analysis Practices and Theory," 55 Financial Analysts Journal 87 (July/August 1999).

¹⁴ Morton, TCM 1997-166.

¹⁵ TCM 2002-34.

¹⁶ Earles and Duett, "Capital Asset Pricing Model for Valuing Closely Held Companies," 5 Val. Strat. 12 (July/August 2002).

¹⁷ Estate of Andrews, 79 TC 938 (1982); Estate of Campbell, TCM 1991-615; and Estate of Smith, TCM 1999-368.

¹⁸ Note 2, *supra*.

EXHIBIT 1**Three-Year Average Earnings Rates of Return on Net Asset Value for the Pricing Period (August/September 2002)**

	Net Asset Value	3 Year Average Earnings	3 Yr. Avg. Earnings as a % of NAV	Average Discount From NAV	Median	Average
First Quartile						
	(\$000)	(\$000)				
Corporate Realty Income Fund I	46,245	(2,637)	-5.7%	18.6%	28.8%	29.7%
Rancon Realty Fund IV	34,056	(438)	-1.3%	42.4%		
Rancon Realty Fund V	41,956	(167)	-0.4%	31.9%		
Brown Benchmark Properties	10,500	129	1.2%	25.7%		
Second Quartile						
ChrisKen Growth and Income II	3,281	100	3.0%	11.3%	27.6%	25.9%
Rancon Income Fund I	4,841	163	3.4%	37.0%		
InLand Land Appreciation Fund I	32,256	1,127	3.5%	29.5%		
Uniprop MHC Income Fund II	49,584	1,914	3.9%	25.8%		
Third Quartile						
Wells Real Estate Fund IV-A	12,934		4.0%	21.8%	13.5%	14.4%
Wells Real Estate Fund VIII-A	31,636	1,330	4.2%	8.7%		
Wells Real Estate Fund VI-A	22,550	1,063	4.7%	13.5%		
InLand Capital Fund	36,573	1,756	4.8%	28.8%		
Wells Real Estate Fund IX-A	32,881	1,672	5.1%	-0.7%		
Fourth Quartile						
Inland Real Estate Corporation	699,896	35,870	5.1%	7.1%	22.7%	24.1%
Uniprop MHC Income Fund	18,150	944	5.2%	34.6%		
ChrisKen Partners Cash Income	15,285	817	5.3%	17.0%		
First Capital Income Properties XI	16,883	1,058	6.3%	22.7%		
InLand Land Appreciation Fund II	66,142	5,332	8.1%	39.2%		

tions such as *Morningstar Mutual Funds* ("Morningstar") and *The Wall Street Journal*. Morningstar provides comprehensive coverage of both closed-end and open-end mutual funds, including various useful measures of return on investment that can be considered in valuing an investment holding entity with marketable securities. *The Wall Street Journal* publishes weekly NAV-per-share and market-price-per-share information that is used in establishing the relationship existing between minority-interest-basis market prices of the securities of CEICs and their underlying NAVs.

A starting point for the selection of guideline CEICs that mirror the asset composition of an investment company holding marketable securities is to segregate the holding entity's securities into relevant categories. *The Wall Street Journal* classifies the CEICs on which it reports into several useful major categories. These major categories include:

- General equity funds.
- Specialized equity funds.
- Preferred stock funds.
- Convertible securities funds.
- World equity funds.

- U.S. government bond funds.
- U.S. mortgage bond funds.
- Investment-grade bond funds.
- Loan participation funds.
- High-yield bond funds.
- Other domestic taxable funds.
- World income funds.
- National municipal bond funds.
- Single state municipal bond funds.

These broad categories are further refined into expanded categories by *The Wall Street Journal*. These expanded categories are useful, depending on the specific valuation assignment. For example, if the investment holding entity to be appraised is funded predominately with Florida municipal bond issues, the Florida Municipal Debt Funds expanded category may be useful to substantiate the minority interest discount. The relevance and sufficiency of guideline CEICs are critical criteria in forming a focused selection process. The judgment of the analyst and materiality of specific asset categories are also essential factors worthy of consideration.

Once a relevant and sufficient group of CEICs has been selected for comparative valuation purposes, some qualitative

factors may be addressed. Some qualitative comparisons worthy of consideration include the relationship between market value percentage and portfolio diversification (or lack thereof), asset allocation, and investment objectives.

Quantitatively, rate-of-return analyses comparing market value percentages of NAV and rates of return on NAV are fundamental to a well substantiated valuation of an investment entity holding marketable securities. As noted with regard to real estate investment entities, the practical expectation regarding rates of return is that there is an inverse relationship between rates of return and discounts from NAV. Specifically, the expectation is for those public analogs with higher rates of return to sell at lower discounts or premiums to NAV, and those public analogs with lower rates of return to sell at higher discounts.

Once again, a thorough analysis of the subject entity relative to the guideline entities in terms of both qualitative and quantitative factors should assist the analyst in "fitting" the subject entity's market value percentage of NAV among the guideline entities.

Operating Entity Valuation

For this discussion, an operating entity is defined as a business enterprise that has, as a primary objective, the active involvement of providing a product or service. A primary function in valuing a closely held operating entity is an understanding of the fundamental position of the entity (again, both in absolute terms, and relative to any companies deemed to have similar investment characteristics and used to provide valuation guidelines). In order to gain this understanding, qualitative and quantitative considerations must be considered. Issues related to valuation methodology for operating entities that will strengthen the opinion of value will also be addressed.

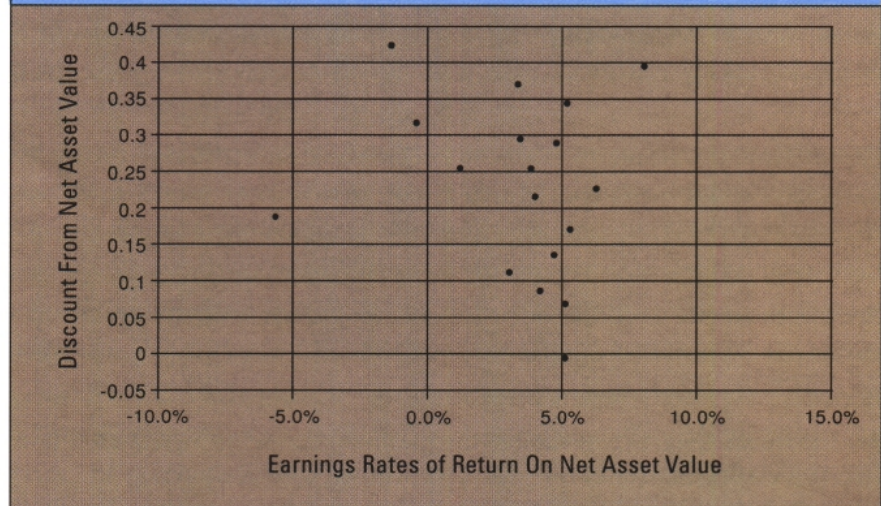
From a broad perspective, the fundamental position of an operating business is explained in both qualitative and quantitative terms. More often than not, insightful due diligence is the most effective means to ascertain the qualitative characteristics of the business. From a quantitative perspective, the fundamental position of the business is often ascertained through insightful financial statement analysis, which is described in the portion of the report related to the review of the income statement and the balance sheet. It should be the primary objective of the analyst to "tell the story" of the operating entity in a cogent manner, both qualitatively and quantitatively.

Qualitative Factors. With respect to qualitative considerations, a primary objective is to describe the business in terms of its history, current status, and prospects for the future. In many respects, an operating business is a function of the interaction of the people involved in the enterprise. This phenomenon is more pronounced in the closely held business, because frequently one or two key individuals may have a profound effect on the enterprise. Thus, it is essential for the analyst to have a complete understanding of the qualitative factors affecting the enterprise, and their impact, in order to form the basis for comparing the enterprise with the external capital market data. In essence, it is imperative for the analyst to tell the story of the enterprise in a manner that leads to understanding the enterprise and sets the stage for the valuation analysis and conclusion that follow.

As an example of the impact of a key management individual and the culture

EXHIBIT 2

Three-Year Average Earnings Rates vs. Discounts From Net Asset Value
(August/September 2002)



of a particular enterprise, consider the following. Several years ago, two of the authors of this article were assigned to the valuation of a closely held gold mining company located in Mexico. This particular company was a small concern that conducted operations from a single mine. In comparison to the public guideline companies selected as market analogs, this mine was much smaller, less diversified, and less attractive in many respects, yet this concern was able to produce gold at a cost per ounce that compared favorably to the larger public companies. Our expectation was that the larger public guideline companies would have significant advantages due to economies of scale and other advantages, and therefore would be able to produce gold much more economically. Prior to the interview with management, we were perplexed as to why the closely held subject entity compared favorably to the public analogs with respect to production costs.

After the management interview, we became convinced that one of the major reasons the subject entity was able to produce gold on a competitive basis with much larger companies was due to the managerial talents possessed by the lead executive of this firm and the impact of Mexican cultural paradigms. This particular individual possessed an extensive technical background in mining engineering, and worked in an executive capacity for many years. Based chiefly on our observations during our site visit, we concluded that this key individual was able to run a highly effi-

cient business enterprise due to two primary reasons. The first reason was attributable to this individual's aforementioned technical and executive talents. The second reason was a cultural factor present in Mexico; the reverence and respect the employees had for senior authority figures such as this particular executive. Because labor comprises a major factor in the cost of gold procurement, this company's parity with respect to gold production costs was chiefly attributable to key person and cultural factors.

A comprehensive discussion of issues that should be addressed in a management interview is beyond the scope of this article; however, several thoughts are in order to help the analyst understand the fundamental position of the entity being valued from a qualitative standpoint. First, preparation is key. The investment of preparation time can add greatly to the effectiveness of the management interview. Frequently this preparation time can evoke more insightful lines of questioning that assist the analyst in understanding the entity. Second, the analyst may consider the frequent use of open-ended questions to draw out a complete understanding of the entity. A question such as, "What accounted for the company's revenue growth over the past three years?" is an example. Third, the analyst may also consider the frequent use of the question "why?" For example, "Why did cost of goods sold increase?" and "Why did the company experience significant employee turnover recently?"

Quantitative Factors. With respect to quantitative considerations related to operating entity valuations for federal tax purposes, comments will be restricted to two areas: financial statement analysis and valuation methodology. The discussion of financial statement analysis will address techniques related to common size analysis and financial ratio analysis. The discussion of valuation methodology will provide some observations on the use of the market, income, and asset approaches in a federal tax environment. Recent opinions of the Tax Court dealing with the use of these approaches will also be explored.

Financial statement analysis. In many instances, the quantitative analysis of an operating entity begins with common size analysis. With respect to the balance sheet, common size analysis facilitates the identification of year-to-year variations in balance sheet accounts. On the income statement side, common size analysis assists in identifying trends and variations of revenue, expenses, and profit margins. Ideally, common size analysis should be conducted prior to the management interview so that variations may be discussed with management at the time of the site visit. In addition, if the entity prepares annual budgets, a very good technique for the analysis of the income statement is to compare prior budgets with the corresponding income statement. This technique can provide insight into the entity's profitability outlook.

Financial ratio analysis is a time-tested tool in the valuation of operating entities. Financial ratios are commonly classified into four primary categories: liquidity, leverage, activity, and profitability ratios. A rigorous analysis of one or more financial ratios within each of these four categories is warranted to facilitate comparison of the subject entity to the industry or the guideline company ratios. A useful technique to convey financial ratio analysis graphically is through the use of charts. Commonly, the subject entity ratios are compared against the median ratios of the guideline companies used in the market approach.

Valuation method. The analyst should research and analyze all material qualitative and quantitative factors related to the operating business prior to employing the appropriate valuation approach.

An objective of this phase of the valuation project should be to reconcile the qualitative and quantitative factors associated with the operating entity being valued. For example, an increase in raw material costs due to commodity price fluctuations, if material, would likely correspond to an increase in cost of goods sold. It should be noted that a primary function of summarizing the qualitative and quantitative factors is to highlight the strengths and weaknesses of the subject entity, a process that ultimately assists the analyst in the determination of the ongoing, normalized earning power of the business, which is arguably the most important determination of the valuation process.

The approach used for the valuation of a closely held business interest is perhaps the most important task in rendering an opinion of value for federal tax purposes. Arguably, the Tax Court and the IRS have exhibited a preference for the use of the market approach for the valuation of closely held business interests.⁶ Rev. Rul. 59-60 specifies that one of the factors to consider is "the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter."⁷

A major advantage of the market approach for the valuation of operating entities is that it is generally more dependent on objective capital market data than the income approach. As a result, perceived subjectivity is minimized in the valuation process. This thought is suggested by another quote from Tax Court Judge David Laro, "[T]ax valuations often rely on market-driven multiples such as price-earnings, price-cash flow, or price-book value ratios, because it is difficult, if not impossible, for the appraiser to (1) confidently make future projections which would be readily accepted by hypothetical willing buyers and (2) establish a universally acceptable discount rate."⁸ In addition, there is a great body of capital market data available to employ in the market approach.

Finally, and possibly most importantly, the market approach is easy to explain and understand. This can be critical in a contested environment, as is often the case in valuations for federal tax matters. Accordingly, the ana-



lyst should strongly consider the use of market approaches for the valuation of closely held operating entities.

The market approach has been criticized largely over questions whether sufficient and relevant data exist to derive credible valuation conclusions. With regard to sufficiency, common sense dictates that if a small number of market analogs are used in the analysis, the value conclusion will be less reliable. In a recent opinion, the Tax Court indicated that it is preferable to use more than three guidelines.⁹ However, assuming sufficient market data exists to employ a market approach, relevancy of the market data may be a key area to address to aid in the acceptance of the value opinion. Relevancy can pertain to numerous factors, including the industry in which the market analogs operate compared to that of the business being appraised, and the applicability of the analogs from a qualitative and quantitative standpoint vis-à-vis the business being appraised. The Tax Court addressed relevancy issues related to the market approach in two recent opinions.¹⁰ Despite certain obstacles, because of an indicated preference of the Tax Court¹¹ and the IRS, it is prudent to employ the market approach if at all possible.

Income approaches, because of the inherent subjectivity involved in their



preparation, are open to stiff challenge. Although the theoretical foundation for the income approach is undeniably sound, practical application of the approach in a federal tax environment may present hazards. Single-period capitalization methods and discounted future returns methods are commonly very sensitive to the underlying assumptions, and can yield wide variations in value conclusions with even minor changes to these assumptions. Several commentators have noted that “the discounted economic income methods are extremely sensitive to changes in input variables—that is, the projected cash flows and the discount rate.”¹² Another commentator stated, “when faced with the reality of the marketplace, the task of projecting earnings, dividends, and a stock price into the future and determining an appropriate discount rate may be too fraught with uncertainty for analysts to rely on discounted cash flow (DCF) analyses in the determination of value.”¹³

The risks of relying solely on the discounted cash flow method in appraising an operating company were exposed in a recent Tax Court opinion.¹⁴ This case presented evidence relating to the value of a computer software and hardware retail concern that ranged from \$55 per share to \$15,000 per share. The taxpayer’s appraiser relied solely on the

income approach to value, stating that he did not use the market approach because he believed there were no sufficiently comparable companies in existence as of the valuation date. The court was critical of the analysis, stating that the results “fluctuate wildly with minor changes in basic assumptions.” In rejecting the taxpayer’s expert valuation in its entirety, the court concluded, “the volatile nature of [the expert]’s valuation model, along with the lack of objective support for his assumptions, causes us concern about the accuracy of his final calculation.”

Another disadvantage of the income approach is related to the complexity associated with supporting applicable return rates. Commonly, support of such rates is achieved through the use of the build-up method or the capital asset pricing model (CAPM). Recently, the Tax Court in *Estate of Heck*¹⁵ addressed the use of build-up methods and CAPM:

In recent cases, we have criticized the use of both the capital asset pricing model (CAPM) and WACC as analytical tools in valuing the stock of closely held corporations. See *Furman v. Commissioner*, T.C. Memo 1998-1578. See also *Estate of Maggos v. Commissioner*, T.C. Memo 2000-129 and *Estate of Hendrickson v. Commissioner*, T.C. Memo 1999-278, which reaffirm

that view, citing *Furman*, and *Estate of Klauss v. Commissioner*, T.C. Memo, 2000-191, where we rejected an expert valuation utilizing CAPM in favor of one utilizing the buildup method. In other recent cases, however, we have adopted expert reports which valued closely held corporations utilizing CAPM to derive an appropriate cost of equity capital. See *BTR Dunlop Holdings, Inc. v. Commissioner*, T.C. Memo 1999-377; *Gross v. Commissioner*, T.C. Memo 1999-254, *affd.* 272 F. 3d 333 (6th Cir. 2001).

CAPM was also discussed in detail recently in this publication,¹⁶ and the authors concluded that CAPM can be a valuable resource if properly justified. This conclusion seems to be in concert with Judge Halpern’s comments, and in spite of a possible bias of the Tax Court for the build-up methodology.

Although the asset approach is not generally applicable in most going concern valuations, a scenario involving an operating entity with high asset value and a relatively low level of earning power may be one exception. In these scenarios, reliance on both an earnings-based approach (such as an income approach or a market approach), along with an asset approach, can be particularly persuasive. The Tax Court, in at least three opinions,¹⁷ has endorsed the use of both an asset and an earnings approach to the valuation of an entity with high asset value and significant operating characteristics. A recent Fifth Circuit decision also allowed this approach.¹⁸ In *Andrews*, the Tax Court stated:

[R]egardless of whether the corporation is seen as primarily an operating company, as opposed to an investment company, courts should not restrict consideration to only one approach to valuation, such as capitalization of earnings or net asset values. Certainly, the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to the values arrived at under the different approaches, but it should not dictate the use of one approach to the exclusion of all others.

Therefore, appraisers who encounter such a scenario (*Continued on page 45*)

Appraisal Techniques

(Continued from page 13) may want to consider similar valuation methodology, as this approach has prevailed before.

Lack of Marketability Discounts

Much discussion has surrounded the topic of lack of marketability discounts for closely held business interests, and for good reason. Frequently the lack of marketability discount is the single largest adjustment for the valuation of a minority interest in a closely held business. As with other areas of business valuation practice, the strength of the discount for lack of marketability is directly related to the strength of the capital market evidence, and analysis of that evidence used to support the discount. While it is beyond the scope of this article to provide a detailed discussion related to lack of marketability discounts, it will, however, attempt to provide some insight into the support, and ultimately the effectiveness, of lack of marketability analysis in a federal tax environment.

In recent years, three approaches of supporting lack of marketability discounts have been observed in Tax Court. The first approach, the IPO approach, involves the comparison of market prices of shares in firms following initial public offerings (IPO) to private transaction prices of those same firm's shares preceding the IPO. The second approach, the restricted stock approach, involves the comparison of private placements of restricted shares in publicly traded issues with the market price of unrestricted shares in the same issue. The third, and most recent, approach, the quantitative approach, uses quantitative models to substantiate discount.

IPO Approach. As noted previously, the IPO approach compares transactions in the stocks of companies that were private at the time of the transaction with their subsequent IPO issuance prices. The lack of marketability discount is generally determined by measuring the difference between the stock's trading price in transactions prior to the IPO and the IPO issue price.

The use of the IPO approach as support for lack of marketability discounts has been disparaged for several reasons:

1. Private transactions preceding the IPO are presumed to have occurred at fair market value in arm's-length transactions, a prerequisite for the hypothetical willing seller and hypothetical willing buyer, necessitated by the fair market value standard of value.
2. Because many companies undertaking an IPO have rapidly growing earnings and therefore, increasing values, the lack of marketability discounts derived from an IPO approach may be biased for supporting higher discounts.
3. An IPO approach may also be biased because data is used only from companies that consummate a successful IPO. This data excludes companies that are poor performers that choose not to attempt an IPO or those companies that fail to complete the IPO process. Moreover, the very fact that a company has undertaken an IPO may significantly increase the value of the company.

4. The public may react differently to an IPO in which the company is raising new equity than if the shares are being sold by existing stockholders. These factors may lead to widely different discounts.

Restricted Stock Approach. For many years, the restricted stock approach has been used to substantiate lack of marketability discounts within a federal tax environment. As indicated earlier, the purpose of the restricted stock approach is to compare the per-share prices paid in private placements of restricted stock with the same company's freely traded, stock market price. The difference in price is largely attributable to the lack of liquidity associated with the restricted stock. In contrast with privately held securities that will likely never have the ready liquidity of a public stock, the restricted stock can be expected to be freely traded after the Securities and Exchange Commission (SEC) holding period requirements are satisfied. Often in the case of private entities, shareholders' agreements, partnership agreements, or operating agreements have restrictions that effectively preclude any form of public offering. Many analysts believe the restricted stock approach, if applied properly, is the strongest approach to support a lack of marketability discount because the approach relies on objective capital market evidence. In one recent Tax Court opinion, the court seemed to imply that restricted stock approaches were preferable to IPO approaches.¹⁹

On the other hand, the restricted stock approach has been criticized because of the relevance of the data for valuing non-marketable interests in closely held businesses, frequent reliance on averages, and the lack of specific analysis of the business interest being valued. However, are these blanket criticisms of restricted stock approaches appropriate, given that some of the most recent restricted

stock studies²⁰ have analyzed the salient factors associated with the private placement transactions of restricted stock that affect impaired marketability? These studies have attempted to relate various independent variables (such as size of revenues and earnings, stability of revenues and earnings, and price stability) to size of discount.

Quantitative Approach. The quantitative approach attempts to support lack of marketability considerations based on assessments of certain criteria that may be considered by market participants. These criteria include capital appreciation, dividend yield, term of investment, prospects for liquidity, and required holding period. In theory, the quantitative approach is conceptually sound. The practical application of a quantitative approach typically involves numerous assumptions regarding the aforementioned criteria that may erode the reliability of the derived conclusion.

Thus far, the use of a quantitative approach to substantiate lack of marketability discounts has not fared well in a federal tax environment, and the viability of such approaches for such a task is for the present time in question.²¹ The lack of success of quantitative methods as support for lack of marketability discounts may be attributable to several sources, and some of these sources may be similar in nature to the deficiencies previously discussed in discounted future returns methods. First, and perhaps most importantly, quantitative approaches have been criticized for their reliance on assumptions rather than hard capital market evidence. Second, because these approaches involve a layering of assumptions, they may well produce an unreliable conclusion resulting from a multiplication of errors related to the underlying assumptions. Third, the conclusions yielded by quantitative approaches are sensitive to minor changes in the underlying assumptions.

Because of the aforementioned limitations, relying solely on a quantitative approach to substantiate a lack of marketability discount is not advisable in most situations involving valuation for federal tax matters. As a result, it may be prudent to limit the use of quantitative approaches corroborating the discount.

Other Considerations

In many situations in which a valuation is prepared for federal tax purposes, a fully documented report is effective in promoting settlement at IRS administrative levels. In addition, a fully documented report is essential for those matters heard by the Tax Court. This necessity is reflected in the following excerpt by noted commentators:

[M]ost judges of the United States Tax Court, where most valuation cases are decided, have extensive experience and skill in analyzing and deciding valuation issues, and are, in a positive sense, very rigorous and unforgiving in their evaluation of expert valuation opinion. In addition, Tax Court Rule 143(f) requires the parties to prepare and exchange written expert reports at least 30 days before trial. As a result, very little or no oral testimony of experts at trial will be allowed to simply restate the report or to educate the judge about valuation concepts. Oral direct testimony will generally be limited to further explaining, clarifying or augmenting the written report.²²

Given the proliferation of business valuation education, training, and resources in recent years, the ability of the Tax Court to examine and understand valuation analysis should not be underestimated. As a consequence, a more thoroughly prepared report will likely facilitate the Tax Court's acceptance of the value conclusion.

Conclusion

Significant discussion on a broad range of topics has been presented relative to the preparation of a valuation of a closely held business interest for use in a federal tax environment. In particular, discussion has been devoted to the use of capital market evidence, the consideration of qualitative and quantitative factors, and importantly, the valuation methodology used for such valuations. Given the importance of many transactions related to these valuations, consideration of the views presented in this article should augment the ability of the valuation to hold up under scrutiny.

¹⁹ See Estate of True, note 10, *supra*.

²⁰ For example, the FMV Restricted Stock Study and the Management Planning, Inc. Restricted Stock Study.

²¹ See generally Estate of Weinberg, TCM 2000-51 and Janda, TCM 2001-24.

²² Elliott, Culp, and Marsh., *Valuation Practice in Estate Planning & Litigation*, § 1-3.40 (Clark BoardmanCallaghan, 1994).