West Group's

ESTATE & PERSONAL FINANCIAL PLANNING

January 2000

AN ESTATE PLANNING ATTORNEY'S GUIDE TO BUSINESS VALUATIONS: PART THREE

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Part One provided the foundation for this article by addressing the theoretical and conceptual aspects of business valuation practice. Part Two delved into the practical aspects of business valuation practice in its examination of the valuation of operating entities. This month, Part Three concludes our discussion by examining the valuation of investment holding companies, such as family limited partnerships, limited liability companies, and similar entities. I also will look into minority interest and lack of marketability discounts commonly applied to interest in these entities, as well as other discounts commonly encountered in business valuation practice. In our discussion of minority interest and lack of marketability discounts, we identify common deficiencies in establishing and supporting these discounts. Finally, the article concludes by presenting our observations on the expert business appraiser's role in defending the appraisal.

The Asset Approach to Value and the Net Asset Value Method

The valuation of investment holding entities is frequently accomplished by using the asset approach. More often than not, the net asset value method is the most appropriate technique, because holding companies derive substantially all of their value from their underlying assets. As Revenue Ruling 59–60 notes:

> The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely

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> related to the value of the assets underlying stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.[1]

For the purposes of our discussion of minority interest and lack of marketability discounts, it is helpful to consider the basis from which these discounts are applied: i.e., from the net asset value of the investment holding entity on a going concern premise.

Minority Interest (Lack of Control) Discounts

A minority interest discount is defined by the American Society of Appraisers as "a discount for lack of control applicable to a minority interest."[2] A minority interest may be defined as an "ownership interest less than 50% of the voting interest in an enterprise."[3]

The fundamental question that must be answered in the process of supporting the existence and the quantification of a minority interest discount is: What rights and benefits does the minority interest holder possess? The rights and benefits that the holder of a minority interest possesses may be ascertained by identifying the elements or prerogatives of control, if any. Three commentators have suggested some of the more common prerogatives of control:

- Appoint management.
- Determine management compensation and perquisites.
- Set policy and change the course of business.
- Acquire or liquidate assets.
- Select people with whom to do business.
- Make acquisitions.
- Liquidate, dissolve, sell out, or recapitalize the company.

- Sell or acquire treasury shares.
- Register the company's stock for a public offering.
- Declare and pay dividends.
- Change the articles of incorporation or bylaws.
- Block any of the above actions.[4]

Additional factors, including state law and other rights and restrictions agreed to by the parties involved may affect the minority interest holder's rights and benefits.

Proper quantification of a minority interest discount is accomplished through the use of empirical evidence derived from the capital markets. In the context of private investment holding companies, such as family limited partnerships, minority interest discounts frequently are derived by an analysis of capital market evidence that corresponds to the nature of the assets held by the entity. For marketable securities, the capital market evidence may be found by an analysis of the market value to net asset value relationships of publicly traded, closed-end investment companies. For real estate assets, the capital market evidence may consist of the market value to net asset value relationships or publicly registered real estate partnership units. Interestingly, the Service has embraced the use of publicly traded closed-end funds for valuing private investment companies.[5]

Minority interest discounts also are frequently quantified through the use of control premiums. A control premium may be defined as the difference between a pre-acquisition minority interest transaction price and an acquisition price. This control premium may be converted to a minority interest discount by the following formula:

$$\text{Minority Discount} = 1 - (1/(1 + \text{Control Premium}))$$

Without question, the blind application of control premiums to derive minority interest discounts is fraught with landmines. First, the commonly used term "control premium" may be a misnomer, for it might be more aptly referred to as an acquisition premium. The premium over freely traded value that Company A pays for Company B often reflects strategic, synergistic, and other economic considerations. Second, because the majority of acquisitions in the public markets involve operating companies, the use of control premium data for substantiating minority interest discounts for investment holding companies is of questionable relevance.

Interestingly, despite these deficiencies, the use of the control premium to derive a minority discount is fairly widespread. One explanation may be the economics underlying the appraisal assignment. The use of

control premium data as support for minority interest discounts generally is accomplished with relative ease and minimal time expense. The substantiation of a minority interest discount using closed-end investment companies (in the case of securities) or publicly registered partnership units (in the case of real estate) can be a time-intensive process, involving substantially more market research than the mere conversion of a premium to a discount.

Lack of Marketability Discounts

This key valuation allowance may be defined as an amount or percentage deducted from an equity interest to reflect lack of marketability.[6] Lack of marketability may be further defined as "the absence of a ready or existing market for the sale or purchase of the securities being valued"[7] and as "the ability to convert the property to cash quickly, with minimum transaction and administrative costs in so doing, and with a high degree of certainty or realizing the expected amount of net proceeds."[8] As with other components of the appraisal analysis, it is imperative that the discount for lack of marketability be supported by reliable capital market evidence. Preferably, this evidence is obtained through the appraiser's primary research and analysis. Many times the discount for lack of marketability is the single largest adjustment to value in the appraisal process, so the support for this discount should parallel the importance of the valuation adjustment.

The empirical evidence used to support lack of marketability discounts for minority interest holdings generally takes the form of two major and differing analyses: restricted stock studies and initial public offering (IPO) studies. Restricted stock studies compare the price of unregistered stock sold in a private placement transaction with the quoted price of the same stock on the same day. The IPO studies compare transactions in the stock of companies that were private at the time of the transaction with their subsequent issuance price.

The restricted stock studies are based on transactions of Securities and Exchange Commission (SEC) Rule 144 restricted stocks. Restricted stock is commonly referred to as "letter" or unregistered stock and is most commonly held by corporate insiders, affiliates, and financial institutions. An unregistered stock is restricted from trading on the open market for a certain time period. The SEC has imposed these restrictions in order to avoid the dumping of large blocks by these corporate insiders and affiliates on the market at one time, thereby causing price volatility. From time to time, such unregistered shares are sold in private transactions. Because the unregistered shares are not immediately marketable in the

established market for registered shares, such transactions generally occur at prices below the concurrent market prices of the actively traded shares. These private transactions enable appraisers to compare the prices of shares that may not be immediately traded in public markets with the prices of otherwise identical shares in the same company that may be immediately traded in the established public market. Thus, transactions in unregistered shares provide a useful guideline as to the diminution in value arising from the lack of ready marketability.

Over the years, a number of studies of unregistered share transactions have been used by business appraisers as evidence to support lack of marketability discounts. Although the analogy between a restricted public stock and closely held security is sound, the use of research and analyses prepared by *others* (which we will call secondary data) is flawed. Primary data, obtained through independent research and analysis, is universally superior to secondary data, for it represents the work product of the appraiser preparing the entire analysis. The fundamental weakness of the reliance upon secondary data is that the appraiser cannot attest to the research and analysis in support of the conclusion. This is in direct contrast to the use of primary data, which the appraiser will be able to describe and defend.

Quite often, secondary data are cited by appraisers as sole support of a material reduction in value. Certain seminal works, some nearly 30 years old by now, are cited with regularity.[9] These restricted stock studies may be flawed in that many of the largest discounts are witnessed in start-up companies lacking a track record, or failing, money-losing concerns.

IPO studies are the other source of secondary data frequently cited by appraisers in support of lack of marketability discounts. The IPO studies consider transactions in the stock of companies that were private at the time of the transaction, but subsequently went public. The lack of marketability discount is generally determined by measuring the difference in the IPO issue price and the price that the stock traded in transactions prior to the IPO.

Using the IPO studies as support for lack of marketability discounts, however, has been criticized. The IPO studies generally indicate higher lack of marketability discounts that those derived from the restricted stock studies. The specific criticism of the IPO studies and their relative bias towards high marketability discounts is generally directed in two areas. First, transactions preceding the IPO are presumed to have occurred at fair market value in arm's-length transactions. This may not always be the case. Second, historically many IPO's have had rapidly growing earnings and, therefore, increasing values. As a result of the high

growth rates inherent in these stocks, the lack of marketability discounts derived from the IPO studies may be skewed to the high side. Because of the deficiencies of IPO studies, restricted stock analysis is considered by many appraisers to be a superior method of supporting lack of marketability discounts.

Additional Considerations

It is essential for the appraiser to provide sufficient and compelling evidence obtained directly from the capital markets to substantiate the discounts used in the analysis. As one commentator notes, "The valuation of closely held business interests is one of the most common yet problematic issues dealt with in transfer taxation. The use of competent appraisers and appraisals is absolutely crucial in maximizing transfer tax savings to taxpayers by determining the existence of, and quantifying, valuation discounts permitted by case law."[10]

Common deficiencies in the substantiation of discounts include: (1) over-reliance on articles, studies and court cases; and (2) combining minority interest and lack of marketability discounts. Generally speaking, triers of fact prefer independently obtained data and analyses that are obtained first hand by the appraiser and applied to the specific facts and circumstances at hand. *Articles and studies performed by others do not represent data and analysis applied to the specific facts and circumstances at hand. Worse than studies and articles, prior court cases do not represent empirical evidence to support a valuation conclusion.* "Courts reject quantification of variables based on past court cases, demanding specific evidence relevant to the case at bar."[11]

Combining discounts for lack of control and lack of marketability is conceptually inappropriate. "The two discounts (lack of marketability and minority interest) are distinct, however, as explained by the Tax Court in *Estate of Andrews v. Comm'r,* 79 T.C. 938, 953 (1982) . . . two conceptually distinct discounts are involved here, one for lack of marketability and one for lack of control. The minority shareholder discount is designed to reflect the decreased value of shares that do not convey control of a closely held corporation. The lack of marketability discount, on the other hand, is designed to reflect the fact that there is no ready market for shares in a closely held corporation."[12]

Other Discounts

Various other discounts relative to business interests and interests in real property are commonly encountered. These discounts include:

1. Investment attractiveness discounts.

2. Discounts for fractional (undivided) interests in real estate.
3. Built-in capital gain discounts.
4. Blockage discounts.
5. Market absorption discounts.
6. Key person discounts.
7. Non-voting stock discounts.

The subsequent paragraphs discuss each of these discounts.

Investment Attractiveness Discounts

This valuation allowance considers the public guideline companies (or any market-based benchmark entity) and the relative attractiveness of the subject interest against various criteria. These criteria may include size, diversification, key customers, or accounts, growth rate differentials and contingencies. This adjustment may either be downward (a discount) or upward (a premium).

Discounts for Fractional (Undivided) Interests in Real Estate

Discounts for an undivided interest in real estate are associated with the lack of control, lack of marketability, and costs of partition of an ownership interest of less than 100% fee simple interest in real estate. In theory, the most relevant evidence to consider in support of a discount for an undivided interest in real estate would be an analysis of comparable sales of undivided interests. There are, however, two major problems with using comparable sales of undivided interests in support of such a discount. First, arm's-length sales of fractional interests in real estate are virtually nonexistent in many markets. One of the authors of this article has personal knowledge of a search conducted by a colleague in a major metropolitan area over an 18-month time period. This search uncovered not a single, verifiable arm's-length transaction in an undivided interest in real estate. (Intuitively, this would suggest the discounts applicable to undivided interests in real estate should be substantial.) Second, a reliable valuation of the fee simple interest in the comparables must be known in order to quantify the magnitude of the discount.

Because of these obstacles, business appraisers increasingly are being called on to support discounts for undivided interests in real estate by measuring the impact of lack of control and lack of marketability on these interests. The costs and time to partition an undivided interest in real estate should also be considered in the determination of the overall discount. As one commentator has noted: "One should not expect a court to routinely allow a discount for a fractional interest in real estate. The taxpayer should offer evidence that a particular interest is not readily divisible or separately marketable."[13] (for two interesting cases involving

discounts for undivided interests in real estate see *Estate of Barge v. Commissioner,* TC Memo 1997–188 and *Estate of Williams v. Commissioner,* TC Memo 1998–59).

Built-In Capital Gain Discounts

As a result of the repeal of the General Utilities doctrine, an acquirer purchasing all of the stock of a corporation for a price that exceeds the acquired corporation's cost basis for its assets does not receive a stepped-up basis for those assets. They carry built-in capital gains that will be taxable at the time the assets are sold. Built-in gains can be of particular significance in valuing the stock of real estate or securities investment companies, because the value of their stock is heavily influenced by the value of their underlying net assets. When those assets carry substantial unrealized capital gains, an informed buyer of the investment holding company will adjust the price downward to allow for the capital gains tax attributable to the unrealized gains. Such an adjustment is necessary in order to keep the effective cost of the assets equivalent to the cost they would have had if purchased directly. (Assets purchased directly would have a cost basis equal to their purchase price and therefore would incur a lesser capital gains tax when subsequently sold.) The economic facts should be clearly recognized and allowed for when determining the fair market value of the stock of a closely held investment entity whose assets have unrealized capital gains. Please refer to *Estate of Gray v. Commissioner,* TC Memo 1997–67, *Eisenberg v. Commissioner,* TC Memo 1997–483, revd 19997 WL 663171 (CA2 1998), and *Estate of Davis v. Commissioner,* 110 TC 530 (1998), for recent developments with respect to built-in capital gains discounts.

Blockage Discounts

A blockage discount arises when substantial amounts of traded stock are introduced into the marketplace creating a temporary oversupply and, often, a drop in value. The amount of the discount is determined by consideration of various factors, including the quoted price of the security, the amount of stock and its degree of activity, market depth, size of the block of stock, time, and market trends.

Market Absorption Discounts

Frequently a real estate holding entity has significant holdings that would depress the market if disposed of within a short period of time. In such cases, a discount for market absorption may be appropriate. Commonly, the real estate appraiser responsible for the value of the underlying real property assets of the entity considers this discount. Thus, the discount is reflected within the net asset value of an investment holding company before the business appraiser is involved. For further

discussion on market absorption discounts see *Carr v. Commissioner,* TC Memo 1985–19, *Estate of Grootemaat v. Commissioner,* TC Memo 1979–49, *Estate of Sturgis v. Commissioner,* TC Memo 1987–415, *Estate of Folks v. Commissioner,* TC Memo 1982–432 and *Estate of Auker v. Commissioner,* TC Memo 1998–185.

Key Person Discounts

In many closely held companies, the contribution of one or more persons is of such significance that the loss of the individual(s) may have an adverse effect on the value of a company. The amount of the discount is contingent on the involvement of the individual and how readily the key person's skills, client relationships, and knowledge can be replaced. Key person issues are addressed in Revenue Ruling 59–60: "The loss of a manager of a so called 'one-man' business may have a depressing effect on the value of the stock of such business, particularly if there is the lack of trained personnel capable of succeeding to the management of the company."[14] For a recent, interesting discussion on key person issues see *Estate of Mitchell v. Commissioner,* TC Memo 1997–461.

Nonvoting Stock Discounts

For the valuation of a minority interest in a closely held company with voting and nonvoting securities, the discounts applicable to nonvoting shares also may be quantified by reference to the capital markets. In order to support the discount between a company's voting and nonvoting classes of stock, public analogs with pure voting and nonvoting capital structures, or super-vote/low-vote securities, should have fluid markets in each class.

The value differential between voting and nonvoting stock was one major issue in the recent Tax Court decision, *Estate of Simplot v. Commissioner,* 112 TC 130 (1999). This decision dealt with both voting and nonvoting shares in the J.R. Simplot Co., where the ratio of nonvoting shares to voting shares was almost 2,000 to 1. The disproportionate ratio of nonvoting shares to voting shares posed a significant dilemma for both the appraisers and the judge involved in the case. The value differential between voting and nonvoting shares of the publicly traded companies frequently is observed to range from 3% to 7%. *It would appear that the appraisers' inability to present on-point empirical market evidence (because it did not exist) contributed to a conclusion by the court that the voting shares were worth 63 times the value of the nonvoting shares.* The decision clearly provides a cautionary note to practitioners planning voting/nonvoting recapitalizations at ratios that are extremely disproportionate.

The Business Appraiser's Role in Defending the Appraisal

Without question, the primary goal for the business appraiser is to be in the strongest possible position if and when the appraisal is challenged. Insofar as court testimony is concerned, "An expert should assist the court in understanding the evidence or deciding a fact at issue (Fed. R. Evid. 702). Therefore, the expert should be well qualified generally, and with respect to the specific matters at issue. Otherwise, the value of the expert's opinion will be diminished. (e.g., *Strasser v. Commissioner,* T.C. Memo 1986–579, *Biagiotti v. Commissioner,* T.C. Memo 1986–460)."[15] In assessing the ability of the business appraiser to perform these critical tasks, an evaluation of various criteria is in order. These criteria include assessment of the business appraiser's academic and professional credentials, experience, objectivity, and reaction to constructive criticism. It also is imperative to ascertain the appraiser's use of market-derived support for his or her opinions.

A broad-based business education, including a background in accounting, economics, or finance, is a starting point. Designations and professional testing are more prevalent than 10 or 15 years ago, although relatively few tested individuals have meaningful tax-related experience and longevity. Before recommending the appraiser to your client, you must be certain that the professional and the firm have staying power.

The experience of the appraiser and the success rates of the appraiser and the appraiser's firm in participating in settlements with authorities and in court proceedings is of paramount importance. Substantial inquiries should be made as to the appraiser's experience. These inquiries should determine: (1) how many appraisals have been prepared for ongoing, long-term gifting programs; (2) how many litigation appearances the appraiser and the appraiser's firm have made and with what results; (3) how many appraisals prepared at the reporting or transaction level have resulted in litigation and with what results; and (4) if the appraiser has ever been retained by the Service or served as a result of a court-appointment. Seeking professional advisor references (attorney, CPA, etc.) is always advisable.

Beware that industry experts do not always make the best impressions on the stand. "There is a growing judicial recognition of the profession of business valuation experts, and a concurrent recognition that expertise in an industry does not necessarily translate into expertise in valuation. A good example of this judicial reaction was articulated by Hon. David Laro in a U.S. Tax Court case: 'The fact that Weinberg is knowledgeable about this industry does not compel us to credit the testimony on the Transferred Assets' fair market value. . . . We do not find that

he has expertise in valuing assets for federal income tax purposes. The thrust of Weinberg's expertise centers on marketing, economics, and the like, rather than on the ascertainment of fair market value.'"[16]

The appraiser should remain abreast of all the relevant, specific authoritative guidance on performing valuations in a federal income, estate and gift tax environment, including pertinent Revenue Rulings and Tax Court decisions (see *Rabenhorst v. Commissioner,* TC Memo 1996–92).

It is critical for the appraiser to be objective and conflict-free. Extreme positions can jeopardize your case and your expert's credibility. The appraiser should be an advocate only for his or her opinion, not an advocate for a particular result. "The ultimate goal is not merely to have the expert's opinion on the ultimate issue admitted into the record, but to persuade the trier of fact to accord significant weight to the expert's opinion."[17] The arbiter of value generally will sense the appraiser who takes the advocate's position and will render a decision accordingly. The appraiser also must be free from conflicts of interest. For instance, is the appraiser a member of an accounting firm that has been the subject company's long-term auditor or tax advisor? Is the expert on blockage an investment banker with an expectation of future dealings with the company or its principals?

An appraiser also should be receptive to constructive criticism. Do not hesitate to press the appraiser to support his or her opinion. "Simply stated, tax advisors should review every component of the appraisal with a critical eye, probing, questioning, and forcing the appraiser to justify all conclusions."[18] It may be wise to curtail relationships with appraisers who do not cooperate by explaining their opinions. A professional appraiser with experience in a Federal tax environment will welcome this scrutiny as an opportunity to support the opinion rendered and/or tighten up portions of the analysis well in advance of judgment day before the Tax Court.

Finally, it is most critical for the appraiser to use market-derived evidence in support of the valuation opinion. As we have presented, the most persuasive evidence to support an opinion of value or a discount is based on data that is derived directly from the market and applied to the specific facts and circumstances at hand. The appraiser who follows this tenet will solidify your position and provide maximum leverage in negotiations with the Service. This notion was echoed by Judge Laro: "In recent cases, the Tax Court has expressed a preference for 'real world' valuation over unrealistic appraisal methods."[19]

A very recent Tax Court opinion, *Estate of Smith v. Commissioner,* TC Memo 1999–368, presents an excellent example of the taxpayer's effective

(and successful) use of sound empirical evidence and analysis. The market-based appraisal report of one of the taxpayer's experts on the minority value of stock in an operating farm was characterized as "very persuasive and well supported by his underlying reasoning." Not surprisingly, the expert's 76% discount from net asset value was accepted. More often than not, strong market-based evidence, along with a well-prepared report and cogent testimony will prevail, as evidenced by the Smith decision.

Conclusion

Part One of this article examined the underlying fundamentals and guidance for appraisal practice. In Part Two, we discussed the valuation of operating companies in some detail. Finally, in Part Three, we have considered the valuation of investment holding companies and related discounts. We also looked at the role of the appraiser in defending the appraisal.

Although valuation and the appraisal process can be relatively complex, the fundamentals of practice that we have discussed as the primary tenets of business valuation are straightforward and of substance. Of these tenets, it would appear that adequate investigation and research of the empirical capital market evidence is perhaps the one most commonly overlooked. That being said, if inadequate investigation and research of the capital market evidence does not occur in the appraisal process, it really does not matter how well the other aspects of the appraisal are performed. In other words, the foundation of the appraisal opinion crumbles without the capital market evidence to support the opinion.

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FOOTNOTES

[1] Rev Rul 59–60, 1959–1 CB 237.

[2] American Society of Appraisers Business Valuation Committee, *Business Valuation Standards* at 21.

[3] See notes 2, 4, and 5.

[4] Pratt, Reilly and Schweihs, *Valuing a Business, 3d ed.,* at 301.

[5] Commerce Clearing House, Inc., *IRS Valuation Training for Appeals Officers* (CCH 1998) at 11–10.

[6] American Society of Appraisers Business Valuation Committee, loc. cit.

[7] Commerce Clearing House, Inc., op. cit. at 9–3.

[8] Pratt, *Valuing a Business, 3d ed.,* op. cit. at 332.

[9] Moroney, Robert E., "Most Courts Overvalue Closely Held Stocks," Taxes, March 1973, pp. 144–155. Maher, J. Michael, "Discounts for Lack of Marketability for Closely Held Business Interests," Taxes, September 1976, pp. 562–571.

[10] Keligan, "Appraisal Issues Now Require Greater Attention for Tax Planning to Be Effective," The Journal of Taxation, February 1994 at 101.

[11] Pratt, "Judicial Reactions to Valuation Testimony," Valuation Strategies, September/October 1997 at 22.

[12] Adams, "New Directions in Valuation," 28th Southern Federal Tax Institute September 27–October 1, 1993, at Z–20.

[13] Adams, "New Directions in Valuation," 28th Southern Federal Tax Institute September 27–October 1, 1993, at Z–23.

[14]Rev Rul 59–60, 1959–1 CB 237.

[15]Proceedings of American Bar Association Tax Section, Court Practice & Procedure Committee, Atlanta, Georgia, August 6, 1999.

[16]Pratt, "Judicial Reactions to Valuation Testimony," Valuation Strategies, op. cit. at 21.

[17]The Honorable David Laro, "Valuation Issues and the Role of Experts," Mobile Estate Planning Council Institute, October 3, 1997, at 8.

[18]Keligan, op. cit. at 100.

[19]Laro, "Business Valuation: A View from the United States Tax Court," American Society of Appraisers International Appraisal Conference, Denver, Colorado, June 20, 1995, at 16.