recent developments in the economy and capital markets are extraordinary in many ways. However, in extraordinary times come extraordinary opportunities. Depressed asset valuations and historically low applicable federal rates make the current environment a unique time for family wealth planners to revisit clients’ estate and other tax planning needs. Additionally, time may be of the essence because recently introduced legislation may substantially increase potential tax liabilities of clients by disallowing valuation discounts in a number of cases, as discussed in detail further in this article.

As wealth planners are executing various transfer planning strategies, valuations and the accompanying underlying analytical support will be critical to the success of many planning strategies. This article outlines the environment that estate planners face, particularly as it relates to valuation-related issues; then discusses current valuation methodologies, particularly as they relate to the often-debated discount for lack of control (DLOC) and discount for lack of marketability (DLOM).

Recent Trends
With just about all prognosticators forecasting massive deficits for years to come, elected officials may look to better-funded, more-aggressive enforcement to raise government revenues. This will put a premium on well-conceived and well-executed estate planning, which includes a proper, well-supported valuation analysis. Such planning will have to be carried out in an uncertain legislative environment.

Legislative Environment
The estate tax reform bill H.R. 436, entitled the “Certain Estate Tax Relief Act of 2009,” was introduced on January 9, 2009, by U.S. Rep. Earl Pomeroy, D-ND. According to an assessment by Grant Thornton LLP, the current $3.5-million estate tax applicable exclusion amount and the maximum estate tax rate of 45 percent would be made permanent under H.R. 436. ¹

For gift and estate tax purposes, H.R. 436 would prohibit a DLOM for nonbusiness assets (e.g., a diversified portfolio of marketable securities). Additionally, H.R. 436 would disallow any DLOC for gift and estate purposes if the transferee, while not having unilateral control of the business, has the ability to control the entity together with family members.

As of the writing of this article there is no indication that H.R. 436 is about to become law, but the bill itself highlights the ever-present possibility of legislative change that faces estate planning professionals. While most observers expect some kind of permanent resolution to the estate tax to be reached in the upcoming legislative sessions, the final form of this legislation remains uncertain.

Judicial Environment
Historically, valuation professionals relied heavily on qualitative factors affecting the risk and liquidity of the business and business interest in determining the appropriate discounts for lack of control and marketability. One common approach was to utilize the average of discounts indicated by various studies as a starting point, then make adjustments based on qualitative factors. Recent tax court rulings, however, suggest an increased expectation of utilizing quantitative methods and relying on empirical data to support selected discounts.

As an example, the Estate of Litchfield v. Commissioner was a key case from early 2009 that focused on valuation issues, including discounts for built-in capital gains (which are not discussed in this article) as well as the DLOC and DLOM.² Rather than simply splitting the difference between the sides, which had so often been the case in years past, the court based its decision on the sufficiency and logic of the relative positions taken by the experts in the case. On most issues, the estate’s appraiser prevailed based on the quantitative support provided in the analysis.

Even in the vast majority of cases that ultimately do not go before the courts, a well-reasoned and supported valuation analysis will provide a stronger bargaining position when negotiating settlement with the Internal Revenue Service (IRS). The consensus view of the practitioners that we’ve surveyed is that, under the present administration, the IRS likely will be better-funded with more resources to contest poorly supported valuation analyses. Unless made irrelevant by leg-
islative action, the DLOC and DLOM will continue to be key battleground areas in disputes between taxpayers and the IRS.

Discount For Lack of Control
A discount for lack of control is an adjustment applied by appraisers to consider that owning a business interest that lacks the voting rights to control the operations or key decision-making processes of a business is less valuable than an otherwise identical interest that has such rights. Appraisers have a number of tools for estimating the magnitude of such an adjustment, several of which are discussed below.

Closed-End Funds
Closed-end funds provide market evidence regarding the discounts from net asset value observable in publicly traded investment funds holding marketable securities. Closed-end funds are ideal for determining the DLOC when evaluating holding companies with marketable securities as the primary underlying assets. The nature of the assets held by the subject business is the primary factor to determine the appropriate category of the closed-end funds to utilize.

Acquisition Premiums
Generally, acquirers will pay more for an entire business than for a small minority ownership interest, and, as a result, typically pay an acquisition premium when a controlling interest is acquired. One method of quantifying the DLOC is to examine acquisition premiums for merged or acquired publicly traded companies similar to the subject business. The DLOC is simply the inverse of the control premium associated with the acquisition. Although acquisition premiums can provide objective support for a DLOC, appraisers should consider that acquisition premiums often include a premium for synergies, which must be excluded for the purposes of determining the DLOC.

Minority Interest Discount Database
The Minority Interest Discount Database (MIDD), compiled by Partnership Profiles, Inc., provides information regarding publicly registered limited partnerships that are predominantly invested in real estate. The MIDD lists price to net asset value discounts in the secondary market. The discounts observed in the MIDD typically are applicable to entities with significant real estate holdings.

Market data for each of the three data sources above have suggested larger discounts may be appropriate during the current economic downturn. While this effect is likely temporary, valuation professionals likely will be in a position to support a somewhat higher DLOC until the economic environment more fully recovers.

Discount For Lack of Marketability
A discount for lack of marketability reflects the fact that, all else being equal, a security for which there is a public market tends to be more valuable than a security of a closely held enterprise. Historically, appraisers have concluded DLOMs based on a variety of studies focused on valuations of restricted stock and pre-initial public offering (IPO) securities. These studies provide appraisers with a general range but provide little guidance as to where within the range an appropriate DLOC would fall in a given situation. Nevertheless, these studies have provided the benchmark for DLOC analysis for years. With a greater emphasis being placed on support for the DLOC analyses, more quantitative techniques are evolving, some of which are discussed below.

FMV Restricted Stock Study™
The FMV Restricted Stock Study™ is a database of restricted stock transactions. Unlike the other restricted stock studies referenced above, this study provides additional information regarding key drivers of the discount. Thus, the appraiser is able to quantify the DLOC for the subject interest by analyzing the relationship between various marketability factors and the observed discount.

Valuation Advisors, LLC
Pre-IPO Study
Another means of estimating DLOC is to compare a company’s issue price pre-IPO to the ultimate initial public offering stock price, with the variance yielding an implied discount. Valuation Advisors, LLC compiled pre-IPO marketability discount studies from 2002 through 2006. In all five years of this study, the average discounts were generally higher as the amount of time between the private transaction and IPO increased, which supports the premise that holding period is a major factor in determining the magnitude of the DLOC.

Key Drivers of Valuation Discounts
While the resources and methodologies discussed above are utilized to quantify the general range of discounts, it is important to understand the fundamental concepts driving the valuation discounts. The key factors impacting the magnitude of the DLOC are:

Degree of control. Typically, the greater the influence of the subject interest on the business affairs of the entity, the lower is the DLOC.

Cash flow. The presence of strong interim cash flow would make a non-controlling investment in the subject entity more attractive, thus, decreasing the DLOC.

Competence of management. Typically, large publicly traded businesses are managed by experienced and competent management. The less experienced the management of the subject entity, the higher would the indication of the DLOC be.

Market environment. In tough economic conditions the number of potential investors in private businesses decreases due to uncertainty related to the prospects of the business. The recent increase in market volatility translated into higher observed...
discounts, as investors required greater returns to invest in closed-end funds.

The key factors impacting DLOM are:

Liquidity horizon. The longer the term to liquidate the investment, the greater the DLOM. Various empirical data and marketability studies support this relationship.

Degree of control. Limitations on the rights of noncontrolling investors negatively impact the marketability, thus increasing the DLOM.

Distribution policy. A history of consistent distributions coupled with an income generating asset base and an expectation of significant distributions going forward would make an investment more attractive, thus, diminishing the DLOM.

Transfer restrictions. The presence of restrictions on transfer of the subject interest and/or the inability to withdraw from the business prior to its liquidation would suggest a greater DLOM.

Asset composition of the entity. The greater the liquidity of the underlying assets of the subject entity, the lower the DLOM.

As discussed above, current asset valuations, the low interest rate environment, and potential amendments to tax legislation provide incentive for estate, gift, and other tax planning. In light of increasing scrutiny of valuation reports by the IRS, having a competent business appraiser as a provider of valuation services has never been more important. The appraiser’s qualifications, firm capacity, and track record of utilizing the most recent research, latest methodologies, and resources should serve as the key selection criteria.

Todd C. Fries, CFA®, is an equity holder and executive vice president of Business Valuation Advisors LLC in Plano, TX, where he specializes in the valuation of businesses, business interests, and intangible assets as well as the analysis and determination of lost profits or other economic damages. He earned an MBA with honors from Texas Christian University. Contact him at tfries@bvafirm.com.

Mayis Kirakosyan, CFA®, is a senior valuation analyst with Business Valuation Advisors LLC. He has been involved in hundreds of valuation projects related to financial reporting, employee stock ownership plans, family limited partnerships, and litigations involving valuation of economic damages. He earned an MBA in finance/investments from Texas Christian University, and a BS in economics and an MS in finance with honors from Yerevan State University (Armenia). Contact him at mkirakosyan@bvafirm.com.

Endnotes


3 Partnership Profiles, Inc. (www.partnershipprofiles.com).
