

Discounts: Where are We Now?

By Tony Garvyⁱ

Summary: In almost every business appraisal the inclusion of discounts and premiums are viewed as a necessary, but often controversial, component to arriving at fair market value or fair value. This article discusses the current state of discounts and premiums in business appraisals and reviews some recent court cases regarding same.

Discounts and premiums are a component of almost all appraisals of closely-held businesses. Indeed, the use of discounts and premiums in valuing closely-held business is a fundamental necessity because such appraisals are based on facts and dynamics observed in the public markets. The use of discounts and premiums enable appraisers to reconcile the value differences between less marketable, freely traded securities and minority and controlling interests in closely-held business as well as to make value adjustments based on other characteristics of the subject equity interest being appraised. Appraisers use the public markets as a proxy for which certain value conclusions that can be drawn and applied to the subject equity interest they are appraising.

In 2009, there have been several notable cases dealing with discounts and premiums. Three of these notable cases are discussed below and provide some guidance on structuring transactions to maximize discounts and premiums in the future.

Estate of Litchfield

In *Estate of Litchfield*, T.C. Memo 2009-21 (January 29, 2009), the United States Tax Court analyzed discounts for built-in gains taxes, lack of control and lack of marketability relating to the estate's minority interest in two closely held family corporations. The *Estate of Litchfield* decision follows a string of cases in the last few years that have required the Tax Court to decide on appropriate discounts for companies that were essentially holding companies for real estate, cash and marketable securities.ⁱⁱ

Several unique aspects to the *Estate of Litchfield* provide insight into current discounting and court analysis for valuation issues. Uniquely, there were two different interests at issue, which allow for a comparison and contrast of those interests. Further, the issues were limited to the appropriate percentage discounts as both the estate and the Internal Revenue Service (“IRS” or “Service”) agreed that the net asset valuation method was the proper methodology to appraise the decedent’s 43.1 percent interest in Litchfield Realty Co. (“LRC”) and 22.96 percent interest in Litchfield Securities Co (“LSC”). (Table A below provides a breakdown of the assets held by LRC and LSC.)

Table A: Assets held within LRC and LSC.

LRC		LSC	
Real Estate	\$22,671,055	Marketable Securities	\$49,970,382
Marketable Securities	9,751,757	Cash	2,088,572
Mineral Rights	319,942	Equity Investments	685,108
Subsidiary	300,000	Short-term Investments	100,000
Grain Inventory	244,122	Federal Income Tax receivable	1,500
Prepaid Expenses	156,304	Total Assets	\$52,845,562
Machinery & Equipment	132,782		
Cash	39,414	Less Liabilities	-21,149
Co-op dividends	31,970		
Receivables	-25,062	Net Assets	\$52,824,413
Total Assets	\$33,622,284		
Less Liabilities	-448,088		
Net Assets	\$33,174,196		
Estate’s % owned:	43.1 %	Estate’s % owned:	22.96 %

In analyzing the appropriate discount for built-in gains, the court looked to the *Jelke*ⁱⁱⁱ and *Dunn*^{iv} cases that previously dealt with built-in gains tax discounts as offsets to the net asset value of an estate. In both *Jelke* and *Dunn*, the courts essentially held that the built-in gains tax discount should provide a dollar-for-

dollar reduction of the entire built-in capital gains tax liability under the arbitrary assumption that all corporate assets would be liquidated on the date of death.

In contrast to *Jelke* and *Dunn*, the estate's expert in *Litchfield* didn't presume that all the assets held by LRC and LSC would be sold as of the valuation date. Rather, the estate's expert based his analysis on historical asset turnover, conversations with management, and board minutes indicating an intent to sell some assets in the near future. As a result of his analysis, the estate's expert projected an average asset holding period of 5 years for LRC and 8 years for LSC, respectively. Then, based on his projected average asset holding periods and the applicable capital gains rate, the estate's expert determined that a discount of 17.4% was appropriate for LRC and a discount of 23.6 was appropriate for LSC.

The Service's expert, however, based his analysis solely on historical asset sales. Notably, the expert didn't meet or interview management. As a result of limiting his analysis to historical sales, the Service's expert projected an extraordinarily long holding period for the assets: 54 years for the assets in LRC and 29 years for the assets in LSC. Because LRC, as a result of its S corporation election on January 1, 2000, would no longer be required to pay corporate-level capital gains taxes beginning in 2010, the Service's expert did not include in his calculation of a capital gains tax discount any capital gains that were projected to be incurred beyond 2009. This, in turn, resulted in the IRS claiming that a 2% built-in gains tax discount should apply for LRC. The Service's expert determined that an 8% built-in gains tax discount should apply for LSC based on the projected 29-year holding period. Notably, the *Litchfield* case was already being contested after the *Jelke* decision that allowed a dollar for dollar discount for built-in gains, and therefore, the taxpayer was not able to make an argument for discount of the full amount like that in the *Jelke* case.

The court ruled that the estate's determinations of the built-in capital gains tax discounts were more appropriate than those of the Service. In reaching its decision, the court observed that the estate's expert's assumptions were based on more accurate data (i.e., historical data, recent data and conversations

with management) than were those of the IRS (i.e., historical data and wrong assumptions as to management's plans). Further, the court noted that despite estimating a long asset holding period, the IRS's expert didn't factor into his analysis the asset appreciation over this time period, which would result in a higher present value of capital gains taxes owed.

Concerning discount for lack of control, the Court found the estate's expert's discount for lack of control for LRC of 14.8 percent and LSC of 11.9 percent to be appropriate. The estate's expert witness used a weighted average based on each of the company's underlying assets. The IRS expert used a straight average – which failed to account for the unequal mix of assets owned by the companies.. Further, the estate's expert gave the LSC discount for lack of control more weighting due to the lesser interest of 22.96 percent for LSC versus 43.1 percent LRC. The IRS expert didn't make any additional discount to account for the estate's lower ownership interest in LSC.

The court basically “split the baby” regarding the discount for lack of marketability. The estate's expert used older restricted stock studies and broke those studies out between studies of larger profitable companies that had discounts ranging from 10 to 30 percent and studies of smaller, less profitable and non-profitable companies that had discounts ranging from 30 to 50 percent. Thereafter, the estate's expert assigned numerical values for the underlying assets and other marketability characteristics of LRC and LSC based on a -1 to +1 range where -1 represented poor investor rights and 1 represented excellent investor rights. For example, LSC's cash and short term investments were given a .5 and LRC's farmland holdings were given a -.5 factor. Based on this analysis, the estate's expert asserted a 36 percent discount for lack of marketability for the interest in LRC and a 29.7 percent discount for lack of marketability for the interest LSC.

The IRS's expert used both older restricted studies as well as the new restricted stock studies that were authored in the 1990s. The IRS's expert also reviewed the differential between registered, freely tradable private placement securities and unregistered, not freely tradable private placements. This differential

provided a range of discounts from 7.23 percent to 17.6 percent. The Service also pointed to LRC and LSCs lengthy management history, dividend history, transparent financial conditions and long history of investments that provided returns. The IRS's expert asserted that a discount for lack of marketability of 18 percent was proper for the real estate laden LRC and that a discount of just 10 percent was proper for LSC, which is comprised mostly of marketable securities and cash.

The court concluded discounts for lack of marketability of 25 percent and 20 percent should apply to the estate's respective minority interests in LRC and LSC. In the opinion, the court criticized the estate's expert for only using outdated restricted stock studies:

The estate's expert used some outdated data relating to restricted stock discounts. His discounts are higher than marketability discounts reflected in benchmark studies that included all components of a lack of marketability discount.

Also, the court stated without any support:

We, however, regard the estate's expert's respective 36-percent and 29.7-percent lack of marketability discounts, particularly when combined with the 14.8- and 11.9-percent lack of control discounts we allow, to be high.

A summary of the results of Litchfield is set forth below.

Table B: Summary of Findings in Litchfield Case

	Estate Expert	IRS Expert	Court's Decision
LRC			
NAV	\$33,174,196	\$33,174,196	\$33,174,196
Estate's 43.1%	9,751,757	9,751,757	9,751,757
Discounts			
Built-in Gains Taxes	17.4%	2.0%	17.4%
Lack of Control	14.8%	10.0%	14.8%
Lack of Marketability	36.0%	18.0%	25.0%
Computed FMV	\$6,475,000	\$10,069,886	\$7,546,725
Imputed total discount	54.7%	29.6%	47.2%
LSC			

NAV	\$52,845,562	\$52,845,562	\$52,845,562
Estate's 43.1%	12,133,341	12,133,341	12,133,341
Discounts			
Built-in Gains Taxes	23.6%	8.0%	23.6%
Lack of Control	11.9%	5.0%	11.9%
Lack of Marketability	29.7%	10.0%	20.0%
Computed FMV	\$5,748,000	\$9,565,535	\$6,530,790
Imputed total discount	52.6%	21.2%	46.2%

In sum, the Litchfield is another of a series of cases within the last few years adjudicating discounts disputes involving investment holding companies and partnerships. The court made some sensible observations in ruling more closely to the estate's appraiser and provides some guidance on discounts and valuation trends. Specifically, in siding with the estate's expert's opinion on discounts for lack of control, the court recognized the obvious merits of weighting the discounts by asset classes to produce a weighted average, whereas the IRS's expert merely employed a simple average. In connection with determining the appropriate capital gains tax discount, the court rewarded the estate's expert for determining the companies' asset turnover through discussions with management. Not discussing the business with management is clear misstep in generating a credible result, even if management is a counter-party. The court's opinion regarding the discount for lack of marketability may reflect a trend by courts to prefer more recent restricted stock studies as opposed to the restricted stock studies from the 1960s, 1970s and 1980s. However, changes to Rule 144 in 1990 and 1997 created more options of liquidity and reduced the holding period from two years to one year for restricted stocks. Accordingly, restricted stock studies dated after 1990 and 1997 reflect lower discounts. Unlike the owners of publicly traded restricted stock, however, most owners of closely held stock cannot guarantee a sale within a year, and a market participant, prospective willing buyer would likely discount a bid for a private company over a freely traded comparable by more than just a one year holding period. Consequently, although there are new studies and courts naturally favor more contemporaneous information, the more recent studies may validate the discounts observed in the older studies being the more credible data because of the changes in

Rule 144; the explanation of why the older studies are more appropriate, however, may need to be articulated more clearly to the courts to ensure that the courts understand why the older studies are more pertinent.

Linton & Heckerman Cases

In *Linton v. U.S.*, Case No. C08-227Z (W.D. Wash. July 1, 2009), the court granted the government's motion for summary judgment in a gift tax refund action and held that no discount should be allowed with regard to LLC interests where property was contributed to an LLC on the same day that gifts of LLC interests were made to a trust also created on the same day for the benefit of the donor's children. The *Linton* analyzed the transaction under both the indirect gift and step transaction doctrines. The main issue is the timing, or lack thereof, between the funding of the entity and the gifting.

The court concluded that the gifts constituted indirect gifts of the underlying assets. Treasury Regulation § 25.2511-1(h)(1) provides that contributions made by shareholder to a corporation constitute gifts to the other shareholders to the extent of their proportionate interests in the corporation. Although the regulation does not address LLC or partnership contributions, the court concluded that it applied to such contributions and that for gift tax purposes, the salient factor is whether the donating partner's contribution is apportioned among all the partners or attributed solely to the donor's own capital account. The court explained that if the contribution is apportioned among all the partner's capital accounts, the contribution should be treated as an indirect gift to the other partners. Because the trusts were created and gifts of the LLC interests were made to the trusts on the same date, either before or simultaneously with the contribution of the property to the LLC, the court held that the donor's transfer of property constituted indirect gifts to the trusts of pro rata shares of the assets conveyed to the LLC.

Although not necessary to grant the government's motion for summary judgment, the court also added that the step transaction would apply. The *Holman*^v and *Gross*^{vi} cases were the first cases (both decided

by the same judge) to address the application of the step transaction doctrine in this context and here, the court followed the same general approach outlined in those cases. The step transaction doctrine treats a series of formally separate steps as a single transaction if such steps are in substance integrated interdependent and focused toward a particular result. The court distinguished *Holman* and *Gross*, where the courts found the step transaction did not apply, because those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts. The court also specifically observed that the assets involved in this case (real property, cash, and municipal bonds) were not as volatile as the assets involved in *Holman* (Dell stock) and *Gross* (marketable securities). Thus, in *Holman* and *Gross*, there was real economic risk of a change in value between the date of funding and the date of the subsequent gifts of interests in the entities, while in *Linton*, the donors could not show the volatility necessary to establish a real economic risk associated with any delay between the funding of the LLC and the gifting of the LLC interests.

Heckerman v. U.S., Case No. C08-0211-JCC (W.D. Wash. July 27, 2009), which was decided July 27, 2009 some three weeks after the *Linton* case, resulted in a similar summary judgment victory for the IRS. The court eliminated any discount for gift tax purposes where the donors transferred mutual funds to an LLC and made gifts of LLC interests to trusts for their children on the same day. The discounts applied to these gifts were eliminated because the taxpayer couldn't establish that the transfer of the investments into the LLC occurred before the gifting of the LLC interests and therefore, the court held that the transfer was an indirect gift. The court also found that the step transaction doctrine applied and as in *Linton*, the court distinguished *Holman* and *Gross* because those cases involved some delay between the date of funding of volatile stocks to the entities and the date of the gifts. However, unlike in *Linton*, the court noted that the application of the step transaction doctrine depends on whether there are non-tax purposes to the actions.

In light of *Linton* and *Heckerman*, planners need to be concerned that the IRS will be looking for more material waiting periods between the funding of the gifting entities and the actual gifts. The loss of discounts will certainly act as a deterrent. Further, the length of the delay may depend on the volatility of the assets; the less volatile the assets, the longer the delay should be although there is no clarity on how long of a delay is needed to avoid a step transaction attack. To avoid the indirect gift approach, in addition to ensuring that there is a sufficient delay between funding and the gifting, as contributions are made to a partnership or LLC, the contributions should be added to the contributing partner's capital account.

How Should a Credible Appraisal Handle Discounts?

As the *Litchfield* case clearly underscores, there are unique facts and circumstances in each discount analysis. The more logical and grounded an appraiser can be in applying their discounts the more credible the result. Some areas of contention now seem more settled and other areas of discounting are frustratingly unsettled. Areas that seem to be agreed upon in the last five years of tax cases are:

1. Generally, discounts from closed-end funds are one way of arriving at a credible discount for lack of control. It is up to the appraiser to clearly demonstrate that the assets of the subject interest and those of the publicly traded closed-end funds are most similar;
2. Using a weighted average is a logical way of properly weighting risks for a basket of diverse assets held within an investment holding company;
3. An Adjusted Net Worth Analysis is an accepted valuation methodology for valuing holding companies, per Uniform Standards of Professional Appraisal Practice (USPAP), the *Litchfield* case and other cases; and
4. Providing strong factual foundation, such as a company's historical context and interviews with management and key participants, in arriving at a proper discount should give more credibility to the appraisal.

However, there are areas where the application of discounts continues to frustrate taxpayers, appraisers, the IRS and courts. The discount for lack of marketability, unlike the discount for lack of control, is more opaque and harder to easily quantify. There have been a myriad of studies of IPOs, private placements, restricted stock studies and other studies in the attempt to accurately capture this discount.

As articulated by the *Litchfield* case, the appraiser needs to clearly show how the subject interest compares and contrasts with the various studies out there and also why certain studies (e.g., the newer restricted stock studies) were either included or excluded. One technique that often works is to show the various studies on a grid and compare the similarities with comments and generate a final value range based on the grid. In so doing, you can show to a third party or trier of fact that:

1. A range of analysis was reviewed (multiple studies and analysis); and
2. The subject interest was compared to those studies from a qualitative aspect.

Below is a sample analysis grid of a discount for lack of marketability analysis for a small interest in a finance company in a tax appeal.

Table C: Analysis of Discounts Studies

Source / Study	Average	Comparability to Subject Interest			Comments
		Little	Somewhat	Highly	
SEC Institutional	25.8%			Yes	Includes OTC non-reporting companies
Gelman	33.0%	Yes			Investment companies; detail unavailable
Mooroney	35.8%		Yes		Investment companies: statistical application
Maher	35.4%			Yes	Investment companies: relatively small companies
Trout	43.5%		Yes		Investment companies: statistical application
Standard Research Consulting	45.0%			Yes	Private Placement: very small companies
Willamette	31.2%		Yes		Private Placement: data unavailable
Silber	33.8%			Yes	Private Placement: very small

FMV	23.0%		Yes	companies SIC, private placement, small companies
Johnson	20.0%	Yes		Detail unavailable
MPI	29.0%		Yes	Private placements, data unavailable
Columbia	21.0%	Yes		Detail unavailable
<hr/>				
Average of Sources	31.4%		32%	
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<u>Pre-IPO Studies</u>				
Emory	46.8%		Yes	Long-term; extensive data; many SIC categories, small companies
Willamette	44.2%		Yes	Long-term; extensive data; smaller companies
Val. Advance	48.9%		Yes	Long-term
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Average of Sources	46.6%		46.6%	

This grid above was part of analysis to support a 35 discount for lack of marketability on a 30 percent interest in the subject company.

Additionally, appraisers should analyze the well-known Mandelbaum factors in arriving at the proper discount for lack of marketability.^{vii} (The Mandelbaum factors are 10 factors that the tax court articulated as affecting a discount for lack of marketability.) Also, where appropriate, an appraisal should include a discussion and presentation of court cases of similar assets and the discount of lack of marketability generated in those cases. A credible analysis of the discount for lack of marketability involves both qualitative and quantitative factors and the report must demonstrate a unique understanding of the subject interest and clearly articulate how the discount was generated. Further, by grounding the discount applied from multiple sources (i.e. from more than one of: restricted stock studies, pre-IPO studies, Mandelbaum factors, similar court cases), the appraiser provides a “layered” analysis that lends further credibility to the discount selected.

In sum, the issue of discounts, whether in tax planning or in litigation, is a constantly evolving issue of contention with the IRS and tax courts. Based on the 2009 rulings in *Litchfield*, *Linton* and *Heckerman*,

the courts seem to be looking for logic and analysis grounded in qualitative and quantitative deliberation. Of all the discounts, the discount for lack of marketability will continue to be debated and more and more will be asked of appraisers to ground their discounts with credible analysis.

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ⁱⁱ *Clarissa W. Lappo v. Cit*, T.C. Memo. 2003-258; *Peter S. Peracchio v. Commissioner*, T.C. Memo 2003-280; September 25, 2003, *Estate of Kelley v. Commissioner*; T.C. Memo, 2005-235 October 11, 2005, among others including *Jelke and Dunn cases (see below)*.

ⁱⁱⁱ *Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007).05-15549, November 15th 2007

^{iv} *Estate of Dunn v. Commissioner*, 301 F.3d at 350-5539 (5th Cir. 2002).

^v *Holman*, 130 T.C. 170 (2008).

^{vi} *Gross*, T.C. Memo 2008-221 (2008).

^{vii} *Mandelbaum v. Commissioner T.C. Memo 1995-255 (1995)*.