

# Discounts in Business Valuation: A Perspective on Lack of Control and Lack of Marketability

**IRS Symposium**

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- With Internal Revenue Service, San Francisco
- Review Taxpayer appraisals on Estate & Gift and Corporate / Partnership tax return issues
- Estimate fair market value for income tax, and estate & gift tax purposes
- Areas of Valuation Experience:
  - estate & gift tax; bankruptcy/liquidation; business interruption damages; divorce; employee stock ownership plans (ESOP's); executive compensation; shareholder oppression
- MBA in Finance, University of San Francisco
- Accredited by the American Society of Appraisers
  - ASA designation in Business Valuation  
(business appraisers are not “licensed”)

# My Project Assignments at IRS

- Who are my clients?
  - IRS Estate & Gift Tax Attorneys
  - IRS Revenue Agents
- What are they looking for?
  - Valuation factors used in Taxpayer's appraisal
  - Supporting evidence for TP's valuation factors
  - Tracing (auditing) of TP's underlying facts
  - A fair market value estimate for IRS' position

# Disclaimer for James McCann

- Not involved in determining or advocating IRS policy or tax law on valuation issues
- Employed as an internal consultant to IRS Estate & Gift Tax Attorneys and Revenue Agents on valuation issues
- Represent my own opinions and professional experience as an appraiser
- Views expressed do not necessarily represent the views of the IRS or the United States

# What is a “discount”?

A discount is a reduction in the pro rata share value of a Subject Interest.

Value of entire business: \$100,000

Multiplied by Subject Interest: 20%

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Pro rata value of Subject Interest: \$20,000

(this value is prior to discounts for lack of control and/or lack of marketability)

# Why should there be a discount?

For this example, the 20% shareholder has no control over how the entire business is operated, and cannot sell (aka “market”) their 20% share without permission from the remaining shareholders.

In this example, lack of control (“LoC”) and lack of marketability (“LoM”) decrease the value of the Subject Interest, relative to its pro rata share of the whole.

Note: Even a “controlling” owner might experience a delay in closing a sale of their interest (“illiquidity”).

# What should the discount be?

That's the \$64,000 question...

Pro rata value of Subject Interest: \$20,000

Less, discount(s) for LoC and/or LoM: ???

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Fair market value of Subject Interest: ???

(fair market value on a stand-alone basis)

# What purpose does the discount serve?

The discount compensates the buyer for added risks associated with LoC and/or LoM.

Higher risks  $\approx$  higher expected rate of return

Additional compensation is realized through a higher rate of return on the initial investment.

A higher rate of return is obtained on the same investment asset by lowering the purchase price.

What are the risks from LoC/LoM?

How do we estimate additional compensation for those risks?

What factors should be considered?

# Lack of Control Factors

A non-controlling owner cannot...

- a. Elect directors and appoint management;
- b. Determine management compensation and perquisites;
- c. Set policy and change the course of business;
- d. Acquire or liquidate assets;
- e. Select people with whom to do business and award contracts;
- f. Make acquisitions;
- g. Liquidate, dissolve, sell out, or recapitalize the company;
- h. Sell or acquire treasury shares;
- i. Register the company's stock for a public offering;
- j. Declare and pay dividends; or
- k. Change the articles of incorporation or bylaws.

(Source: Shannon Pratt's Valuing a Business)

# Lack of Marketability Factors

In Mandelbaum, the following were cited for consideration...

- a. Value of a similar corporation's public and private stock;
- b. Analysis of the company's financial statements;
- c. Company's dividend-paying capacity and payment history;
- d. Nature of the corporation, its history, industry position, and economic outlook;
- e. Company's management;
- f. Degree of control transferred;
- g. Restrictions on transferability;
- h. Investor's holding period;
- i. Company's redemption policy; and
- j. Costs associated with a public offering of the stock.

(Source: Mandelbaum vs. CIR, T.C. Memo 1995-255)

# Avoid Double-Counting

Control factors cited by Shannon Pratt, such as...

- Sell or acquire treasury shares; and
- Declare and pay dividends...

...are similar to marketability factors cited in Mandelbaum, such as...

- Company's redemption policy; and
- Company's dividend-paying capacity and payment history.

Mandelbaum also cites: “Degree of control transferred”.

# IRS Revenue Rulings, 1 of 2

- Regarding factors of “control”:
  - 59-60 Section 4.02(g):
    - “[C]ontrol of a corporation...may justify a higher value for a specific block of stock.” (implies lower value for non-control)
  - 83-120 Section 5.02:
    - “Voting rights of the preferred stock...could...increase the value of the preferred stock and reduce the value of the common stock. This factor may be reduced...where the rights of common stockholders...are protected under state law from actions by another class of shareholders.”
  - 93-12 (on family attribution):
    - “[C]orporate control in the family is not considered in valuing each transferred interest for purposes of section 2512 of the [Internal Revenue] Code.” (could new regs change this?)

# IRS Revenue Rulings, 2 of 2

- Regarding factors of “marketability”:
  - 59-60 Section 4.02(g):
    - “[A]n unlisted corporation's stock is more difficult to sell than a similar block of listed stock...”
  - 77-287 Section 4.03:
    - “[R]estricted securities generally are issued at a discount from the market value of freely tradable securities.”
  - 83-120 Section 4.06:
    - “In general, if covenants would inhibit the marketability of the [preferred] stock...such provisions will reduce the value of the preferred stock...”

# Market Data for LoC Discounts

- (just a few) commonly cited sources :
  - Closed-end mutual funds
    - Generally trade below pro rata net asset value
  - Real estate investment trusts
    - Also generally trade below pro rata net asset value
  - Real estate limited partnerships
    - Partnership Profiles/Spectrum (includes some LoM)
  - MergerStat Review
    - Discount as the inverse of a “control premium”

# Market Data for LoM Discounts

- (just a few) commonly cited sources :

## MergerStat Review

- Price/earnings ratios (public vs. private acquisitions)

## SEC Institutional Investors Study

- Restricted shares of publicly-traded stock
- Many similar “restricted stock” studies have been done over the years

## Bajaj: "Firm Value and Marketability Discounts"

- Isolate lack of marketability from other factors

# Hypothetical Examples for Illustration Purposes

- Example 1:
  - 10% limited partner of One-Property, LP
- Example 2:
  - 52% managing member of Two-Properties, LLC
- Example 3:
  - 1% non-managing member of Vacant-Lot, LLC

## One *Possible* Interpretation: 10% LP of One-Property, LP

- Business plan:
  - Can forecast cash flows through liquidation
  - No change in business plan since investment
- Management's representations:
  - Expected sale of investment property in near future
  - Estimated costs and timeline for liquidation of partnership
- Little or no discounts for LoC/LoM:
  - Cash flows to limited partner already reflect lack of control
  - Liquidation (aka “marketability”) costs already considered
  - Can appraise using net present value of future cash flows

One *Possible* Interpretation:  
52% managing member of Two-Properties, LLC

- Subject interest owner has control:
  - Can buy, sell, or mortgage investment assets;
  - Declare and distribute cash dividends;
  - Liquidate or dissolve the company; and
  - Amend provisions of LLC operating agreement
- LoM discount modeled as an in-kind liquidation:
  - Distributing the apt bldgs in-kind [1:1] yields a measurable loss of value to the Subject Interest
  - Cash reserves used to pay legal/professional fees
  - Risks of market exposure period can be avoided

One *Possible* Interpretation:  
1% non-managing member of Vacant-Lot, LLC

- Subject interest owner has few options:
  - Has no authority to change business plan; and
  - Controlling owner is in no rush to do anything
- Significant Discount for LoC/LoM:
  - No current cash flow...No cash flow projection
  - Need permission to sell...But, who would buy it?
  - Costs of litigation would exceed potential benefits
  - BUT...only so much pro rata value to discount away

# Additional Items – 1 of 2

- Lack of Voting Rights:
  - Separate from / in addition to Lack of Control?
- Blockage:
  - Separate from / in addition to Lack of Marketability?
- Lack of Liquidity:
  - Separate from / in addition to Lack of Marketability?
- Exposure Period (before) vs. Market Period (after)
  - USPAP for Real Property vs. Business Valuation

# Additional Items – 2 of 2

- Tiered entities:
  - Should LOC/LOM discounts apply at each level?
  - Will any new Treasury Regulations address this?
- Sanity Checks:
  - What is rate of return on discounted investment?
  - What is buyer's leverage for negotiating that rate?
  - Would seller willingly forfeit that rate of return?
  - Could GP raise LP money under those conditions?
  - Does discounted value of gift serve the estate plan?

# Q & A

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