



Business Valuation, Forensic Accounting and Litigation News of Substance

Of Discounts, Taxes, and Subsequent Events: Three Hot Topics in Valuation

Some of the liveliest debates in business valuation are currently taking place around three topics: 1) when to include subsequent events in a valuation report; 2) whether discounts for lack of marketability apply to a controlling ownership interest; and 3) how to calculate deductions for built-in capital gains taxes. While discounts are a perennial “hot” topic, the other two have risen from recent events in the legal and appraisal communities.

Subsequent events

Earlier this year, the AICPA adopted its *Statement on Standards for Valuation Services* (SSVS 1). Among the many important provisions, the new standards clearly require valuation specialists to account for events that occur subsequent to the valuation date only when these events are “knowable or foreseeable.” Yet some analysts are uneasy about omitting a discussion of subsequent events from their valuation reports, particularly when a judge or jury—or even a client—will want to hear about them.

Many analysts resolve the problem of subsequent events by convincing the court (through their attorneys) to update the valuation report. Many times, the subsequent events won’t materially impact the original conclusions, and analysts are thus able to account for them without substantially altering the bottom line.

But consider the subprime lending crisis, which began as early as the summer of 2007—although the extent of the damage wasn’t felt in the banking and other industries for several months. When did the credit crisis (and its impact) become knowable and foreseeable? The answer may lie in evaluating what the economic experts and financial indicators were saying as of the valuation date. If this date falls in 2007, for example, when perhaps a few economic forecasters were predicting a downturn—but none as dire as the market declines that eventually took place—then the valuation would most likely omit the impact of these subsequent events.

That’s not always what a client or attorney wants to hear. In these difficult cases, it becomes even more important for the valuation specialist to educate the court and the client on the timing of market events and financial inputs. In fact, many believe that it’s the best “teacher” who will also make the best case for the trier-of-fact.

Discounts for controlling interests?

Is there a valid, conceptual basis for applying a discount for lack of marketability (DLOM) to a controlling interest of a private (closely held) company?

Probably not, as by definition, a controlling owner can determine the timing and terms of sale. But public markets

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There are many contexts in which attorneys and business owners might retain a joint valuation expert—during a merger or sale, for instance, a divorce, or a partnership dissolution. A joint appraiser can be a key player in a buy-sell scenario or a pre-litigation settlement. What follows are just a few of the ways to take advantage of a joint valuator—and a few potential problem areas to watch out for:

Cost. A joint expert will most likely reduce the costs associated with an appraisal in any setting, but especially in those cases when opposing experts are so far apart that the parties have to hire a third, independent valuator. This situation arises most often in buy-sell scenarios—but also in divorce cases when the court is confronted with such disparate evidence of value that it appoints a third, “independent” appraiser—at the parties’ cost. By deciding to retain a joint expert up front, prior to any trial proceedings or sales negotiations, the parties can save significant costs related to the documents and information needed to value the business, the time spent investigating these matters, and the types of calculations performed.

Full access to information. When the parties retain a single valuation analyst, they will be more likely to provide greater access to information to support their respective opinions of the business and its future prospects. The valuator will in turn share all of the information with the parties, electronic communication as well as paper documentation, so that everyone is on the same “page,” and greater objectivity is assured.

Experience. When retaining a joint expert, look for seasoned, credentialed business appraisers who have worked on joint assignments in the past. Joint engagements do present unique challenges (discussed below), and familiarity with the process—including how to administer these assignments between adversarial parties—can be critical to a successful result.

Payment. The parties should establish at the outset how to pay for the joint appraisal. If they can’t agree on the typical 50/50 split, then they should address the issue along with any questions regarding scope of work so that—once again, everyone is in agreement.

Communication. Preferably, the appraisers’ engagement will establish rules about communication (as well as payment and scope of work). These rules will encompass communications to and among the parties and their attorneys as well as access to key business personnel, meet-

ings and management interviews, etc. When the meetings occur outside the presence of one or both parties, they (or their attorneys) can have access to the appraisers’ notes or summaries.

Draft report. The parties should also decide whether to review a draft report (for factual accuracy, comprehensive inputs, e.g.) before the valuator issues a final conclusion of value. The purpose is not to alter the preliminary opinion but to ensure that the valuator has considered all relevant facts and information.

Objective mediator. In many cases, a joint expert can essentially become the “trier of fact” regarding valuation issues. As such, the valuator must inspire trust, demonstrating a high degree of integrity and independence by taking an even-handed, objective approach to the assignment. Joint experts who’ve also been trained in mediation and/or alternative dispute resolution may be better equipped to meet with the challenges, especially in a litigation environment.

Challenges. Despite agreeing to hire a joint expert, the parties may have very different interests at stake and perspectives on value. The appraiser must be prepared to balance any opposing pressures from the parties—such as conflicting input, preconceived notions of value, unrealistic expectations—to arrive at a truly independent conclusion. When possible, it might behoove the valuator to seek independent data and sources of information to mitigate a party’s opinion.

Educating the client. In litigation settings, the standard of value will be set by statute and/or case law. Many buy-sell scenarios contain no definition of or provision for determining the standard of value, and the joint expert can help the clients and counsel understand the various standards, their application, and their implications as to value. Similarly, if the buy-sell provisions are ambiguous regarding valuation methods or accounting terms, the joint expert can offer alternatives and interpretative guidance.

Encouraging trust. While the parties—especially those to an adversarial proceeding—may not trust each other, once again, it is critical for the joint appraisal expert to inspire them with trust in the valuation process and its outcome. A joint expert must always maintain neutrality, in act if not in appearance, and disseminate information equally. The more even-handed the administration of a joint valuation assignment, the more successful the outcome—and satisfied the clients. □

Holman v. Commissioner, 130 T.C. No. 12 (May 27, 2008)

The IRS has aggressively—and for the most part, effectively—challenged the efficacy of Family Limited Partnerships (FLPs) as tax avoidance devices, particularly through the application of Internal Revenue Code (IRC) §2036(a). Now, with the Tax Court's binding opinion in *Holman v. Commissioner*, the IRS has resurrected IRC §2703, regarding transfer restrictions, in its scrutiny of FLPs. Moreover, the court addresses discounts for lack of control and lack of marketability—including an interpretation of the holding period component in these determinations.

Four reasons for formation

The Holmans—husband and wife—formed the Holman Limited Partnership (HLP) on November 2, 1999, funded with \$2.8 million of Dell Computer stock. Six days later, they gifted limited partner (LP) interests to each of their four children. The Holmans made smaller gifts of Dell stock to HLP in 2000 and 2001, each time causing reconfiguration of the partnership so that by 2001, they owned just over 12% as general and limited partners, while the remaining LPs owned nearly 88%. Given the overriding reasons for forming the HLP—asset protection and educating the children on wealth management—the partnership agreement included substantial restrictions on the transfer of LP shares, including a “buy-back” provision in the event of a non-permitted transfer.

On their gift tax returns for each of the three transfers, the Holmans relied on an independent appraisal, which applied an overall 49.25% discount to the value of the LP transfers. The IRS challenged the transfers, claiming that the first (1999) was an indirect gift; that §2703 voided the transfer restrictions; and that all the discounts were excessive.

Indirect gift turns on timing

Pursuant to IRC §2512, the IRS argued that the 1999 transfer of Dell stock to the HLP was an indirect gift to the limited partners, relying on two prior decisions: *Shepherd v. Commissioner* (11th Cir. 2002) and *Senda v. Commissioner* (8th Cir. 2006). The court distinguished the two cases on their facts. In particular, in *Senda*, the taxpayers transferred shares of stock to two FLPs on the same day they transferred LP interests to their children. Here, the Holmans didn't gift the LP units to the children until six days later.

The IRS tried to argue that under the “step transaction” doctrine, the HLP formation and the LP gifts were so close in time, the court should treat them

as a single transaction, resulting in an indirect gift. But the court would have had to find that “the legal relations created by one transaction would have been fruitless without a completion of the series,” it said. Given the six days between formation and funding, the court could not find that the HLP was of no legal consequence absent the 1999 gift. “Indeed, [the IRS] does not ask that we consider either the 2000 gift (made approximately 2 months after formation...) or the 2001 gift (made approximately 15 months [later]...) to be indirect gifts of Dell shares.”

Moreover, the taxpayers assumed the risk that stock values would change, even in the six intervening days. These facts gave “independent significance” to each step of the transaction, and while the court declined to draw any “bright line” concerning the amount of time necessary to deem a series of events independent for purposes of the step transaction doctrine, in this case, six days was sufficient.

Transfer restrictions must serve business purpose

Under IRC §2703(a), “the value of any property transferred by gift is determined without regard to any right or restriction relating to the property.” Under §2703(b), however, the value will include the restrictions if: 1) they comprise a bona fide business arrangement; 2) they are not devices to make transfers for less than full and adequate consideration; and 3) their terms are similar to those in arm's-length transactions.

The HLP partnership agreement contained one particular restriction (paragraph 9.3) that, in the event of an unpermitted assignment of an LP interest, allowed the partnership to buy back the interest from the assignee at fair market value based on the assignee's pro rata, distributional share. In attempting to disregard this restriction under §2703, the IRS argued that it could not be part of a bona fide business arrangement because the HLP's primary goals were not business but personal—i.e., to preserve the taxpayers' wealth and “disincentivize” their children from spending it.

The taxpayers argued that the creation of a mechanism—including a buy-sell agreement—to ensure family control of a family business satisfied the bona fide requirement. But the court disagreed, largely because in this case, “we do not have a closely held business.” From its formation, the HLP had simply held Dell stock, and its transfer restrictions served principally to discourage the LPs' dissipation of assets.

Further, in the event of an unpermitted transfer, the restriction would prevent an assigning

LP from realizing the difference in the fair market value of the LP units (which would include discounts) and the units' proportional share of the undiscounted, net asset value (NAV). Under paragraph 9.3, the partnership could dissolve and redistribute that difference to the remaining partners, increasing their interests and effectively resulting in a transfer for less than adequate consideration. Thus, the transfer restrictions did not meet the first two requirements of §2703(b), obviating the court from ruling on the third.

Experts clash on discounts

Both the IRS and the taxpayers presented qualified business appraisers, who agreed that the NAV of the partnership on the date of the 1999 gift was \$2.81 million, based on the number of Dell shares and their publicly traded values. The experts disputed NAV as of the two subsequent gifts. Relying on gift tax regulations, the IRS used averages of the high and low prices of Dell stock on the date of the gifts. Claiming that the rules didn't apply to gifts of partnership interests, the taxpayers used closing values of Dell stock. But the taxpayers cited no authority for disregarding the rules, the court said. Because the partnership's NAV turned "exclusively" on the values of the publicly traded Dell stock, it adopted the IRS' values for the 2000 and 2001 gifts.

In determining the applicable discount for lack of control, both experts relied on data from closed-end investment funds, and each used three samples—one for each gift—of similar size. (In fact, they used many of the same samples.) But although the IRS relied solely on general equity funds, finding them most comparable to the HLP, the taxpayers' expert used seven specialized funds. The IRS calculated median, mean, and interquartile mean discounts for each of his samples; the taxpayers' expert computed only the median, adjusting them an additional 10% upward to account for the HLP's qualitative factors (lack of diversification, etc.). Their conclusions for the discount for lack of control were:

	1999 gift	2000 gift	2001 gift
Taxpayer expert	14.4%	16.3%	10.0%
IRS expert	11.2%	13.4%	5.0%

At trial, the taxpayers' expert admitted that the specialized funds resembled HLP only in their singular focus, and he agreed there was no correlation between the funds' quantitative factors and the discounts at which they traded. He further admitted that his report failed to explain why he included the specialized funds in his samples.

The court calculated the median discounts from this subset of specialized samples (17.1% and 17.8%) and compared them to the medians from

the full sample (12% and 13%). It found the differences "significant," enough to disregard the data and adopt the more reliable general equity fund data. It constructed samples from the data common to both experts, resolving outliers by "following...the lead" of the IRS expert and using the interquartile mean. Overall, the court applied minority interest discounts of 11.32%, 14.34%, and 4.63% to the three respective gifts.

Holding period—little or no influence?

Both experts used restricted stock studies to calculate the discount for lack of marketability (DLOM). From his samples, the taxpayers' expert calculated median and mean discounts of 24.8% and 27.4%, respectively. Because the LP units had "virtually no ready market" and a willing buyer would have "no real prospects" of publicly selling those interests for full value, he concluded that the DLOM should be "at least" 35%.

The IRS expert examined restricted stock studies for three distinct periods and calculated the average discounts for each:

1. Before the SEC adopted Rule 144A (pre-1990), when there was no resale market for restricted stock, the average discounts were 34%.
2. The seven years after 144A, which permitted limited access to a resale market, the average discounts were 22%.
3. The two years following the 1997 amendment of 144A, which reduced the required holding period from two to one year, the average discounts were 13%.

Based on this evolution, he isolated two components that influenced investors in restricted stocks: limited liquidity and the holding period. In particular, he concluded that the 12% decline in discounts between pre- and post-144A was due to the opening of a limited resale market, and it represented the "charge" or incremental level of discounts that investors demanded before 1990, when the market became more liquid [this part unclear: the market didn't become more liquid until after 1990]. The other 22% (of the 34%) was attributable to holding period restrictions and other factors. For private holding companies such as the HLP, which are not subject to legally imposed holding periods or the risks attendant to restricted stock, he said, the discount for lack of marketability was closer to 12%.

Adopting this baseline, the IRS expert analyzed HLP's specific factors: its failure to make distributions and diversify from Dell stock, and its transfer restrictions. The last two factors increased marketability, he said—specifically because Dell is freely tradable and the buy-back provision permitted

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are not entirely liquid, so many analysts believe that some transactional discount is appropriate, no matter what it's called. (Some use the term "controlling non-marketable interest.") Broker fees and legal fees may also enter into the final percentage, to be balanced, perhaps, by the receipt of dividends and other benefits of ownership. Ultimately, the discount will turn on the facts of the case, as well as the analyst's professional judgment.

Built-in gains

In *Estate of Jelke v. Commissioner* (2007), the Eleventh Circuit Court of Appeals reversed an earlier Tax Court ruling that applied a present value approach to potential future capital gains taxes. The current "bright line" rule, in both the Eleventh and Fifth Circuits, is to apply a dollar-for-dollar reduction for the entire unrealized capital gains tax, even if the business has no immediate plans to liquidate.

At the same time, many valuation analysts still prefer to apply the present value of the anticipated future tax. It's more uncertain, but unless a sale of the business is imminent, there may be a stronger argument for measuring the estimated tax, recorded as a current liability. On the other hand, if there are several prospective buyers as of the valuation date, a better case can be made for deducting built-in gains taxes without calculating the present value of a hypothetical, future sale.

Clearly, *Jelke* recognized that the taxes on the sale of these business assets will eventually accrue; the only question is when and how much. Analysts and their attorneys should consider all relevant factors—and applicable law—when establishing the magnitude of imbedded capital gains. □

Tax Court Takes Novel Approach to DLOM ...

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the partnership to dissolve and redistribute the assets to the remaining partners. The withdrawing LP would benefit because, in the event of an impermissible assignment, given the minority and marketability discounts that would apply to the proportional share of NAV, it would be in the LP's economic interest (as well as the partnership's) to negotiate some price between the discounted value of the units and the dollar value of the units' proportional NAV share.

A reasonable buyer would request (and likely receive) a discount ranging from 10% to 15%, the IRS expert concluded. Given his baseline of 12%, he applied an overall DLOM of 12.5% for the LP interests. He made little, if any, adjustment for the holding period, believing that in this case, it had "little, if any, influence."

More credible expert

Once again, the court lacked confidence in the taxpayers' expert and found the IRS expert's approach more persuasive. Observing that if the LP units lacked any available market, the resulting DLOM could conceivably reach 100%, and the gifts would then have zero value. At any rate, the taxpayers' expert failed to persuade the court that his "stopping point" at 35% was "anything but a guess."

The court also believed that the IRS expert correctly considered the partnership buy-back scenario; even if it ran counter to the HLP's stated purpose—to preserve family assets—the purpose might well yield to the partners' economic self-interest. Finally, the court agreed that the holding period, in this case, carried little weight, and it adopted the 12.5% as the appropriate marketability discount. □

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