

Gift and Estate Tax Valuation Insights

FACTORS THAT AFFECT THE SELECTION OF THE DISCOUNT FOR LACK OF MARKETABILITY

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The application of the discount for lack of marketability (DLOM) is often an important procedure in valuations of noncontrolling ownership interests in closely held companies. This discussion will address some of the key factors that affect the valuation analyst's selection of the DLOM, including (1) the subject company dividend payment history, (2) the owner's expected investment holding period, and (3) the subject-company-specific risk.

INTRODUCTION

Closely held (i.e., not publicly traded) common stock is often appraised for gift tax purposes or estate tax purposes. In these closely held stock valuations, it may be appropriate for the valuation analyst to consider the application of a discount for lack of marketability (DLOM).

The application of a DLOM is often appropriate when the valuation methods applied result in a value indication stated on a marketable ownership interest basis, but the subject company or security represents a nonmarketable ownership interest.

The DLOM for a closely held common stock can be substantial. Empirical DLOM studies—which include restricted stock DLOM studies and pre-IPO DLOM studies—have concluded average lack of lack of marketability discounts ranging from 20 percent to 50 percent. The DLOM adjustments allowed in recent Tax Court decisions has ranged between 20 percent and 45 percent.¹

Based on the size of lack of marketability discounts concluded in Tax Court cases and in the empirical DLOM studies, the selection of the DLOM is clearly an important issue in business/security valuations performed for gift tax and estate tax purposes. Given (1) the relatively wide range of observed price discounts and (2) the myriad of company-specific factors that affect the DLOM, valuation analysts should take great care in selecting a DLOM that is appropriate for the particular subject closely held company or security. This discussion will outline the more significant factors that should be considered by the valuation analyst when selecting a DLOM for gift tax or estate tax valuation purposes.

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FACTORS AFFECTING THE SELECTION OF THE DLOM

An investment asset is not simply either marketable or nonmarketable. Rather, there are varying degrees of investment marketability. The numerous DLOM studies provide a starting point (i.e., the indicated average DLOM) to estimate the subject-security-specific DLOM. However, the facts and circumstances of each individual valuation engagement will determine the appropriate DLOM for the subject company or security.

It is a matter of valuation analyst judgment to select a DLOM based on:

1. the empirical DLOM evidence,
2. the theoretical DLOM evidence, and
3. the facts and circumstances of each individual case.

This discussion will address some of the subject-case-specific factors that affect the valuation analyst's selection of the DLOM.

In *Bernard Mandelbaum et al. v. Commissioner*,² Judge David Laro cited nine specific (but nonexclusive) factors for analysts to consider in developing a

DLOM (or discount for lack of liquidity).

The nine *Mandlebaum* DLOM factors identified were as follows:

1. company financial statement analysis
2. company dividend history and policy

3. the nature of the company, its history, its position in the industry, and its economic outlook
4. the company management
5. the amount of control in the transferred shares
6. the restrictions on transferability
7. the holding period for the stock
8. the subject company's redemption policy
9. the costs associated with a public offering

The *Mandelbaum* case has been referenced frequently in subsequent court cases related to the measurement of the DLOM. The *Mandelbaum* factors are intuitive, and they reconcile with the empirical DLOM studies.

Analyses of the *Mandelbaum* factors, the empirical DLOM studies, the theoretical DLOM studies, and other DLOM literature make it clear that dozens of company-specific and security-specific factors affect the magnitude of the DLOM. However, these dozens of individual factors generally fall into three categories:

1. historical and expected dividend payments
2. expected investment holding period
3. the subject company risk

"... the size of the DLOM is directly related to the expected investment holding period."

A discussion of each of these three categories of DLOM factors follows.

Historical and Expected Dividend Payments

In the text, *Valuing a Business*,³ the importance of dividends is clearly explained:

Stocks with no or low dividends suffer more from lack of marketability than stocks with high dividends. Besides being empirically demonstratable, this makes common sense. If the stock pays no dividend, the holder is dependent entirely on some future ability to sell the stock to realize any return. The higher the dividend, the greater the return the holder realizes without regard for sale of the stock.

As the above quote illustrates, it is expected that an investor in a privately owned company would generally prefer some dividends to no dividends. However, when the subject ownership interest is a noncontrolling ownership interest, the valuation analyst should also consider that the level of future dividends may not equal the level of historical dividends.

For example, let's assume a closely held company makes an annual dividend payment equal to 100 percent of its annual cash flow. Furthermore, let's assume this company is capitalized such that every shareholder is related.

Under a typical interpretation of the fair market value standard of value, which disregards family attribution, the willing buyer of a noncontrolling interest in the equity of this hypothetical company will not be a family member. In order for the economic benefits to remain within the family, the subject company may (1) cease paying dividends and (2) allocate the capital previously used for dividends to the family members in the form of increased salaries, for instance.

In this example, the presence of historical dividends is not the only factor to consider when analyzing dividends relative to a private company. The expected future dividends of the subject company should typically be considered in a DLOM analysis.

This example also illustrates the importance of considering the facts and circumstances specific to each subject company—and of not simply applying a DLOM based on an average of DLOM study percentages.

Expected Investment Holding Period

The second factor that affects the selection of the DLOM is the expected investment holding period. The expected investment holding period was specifically identified in *Mandelbaum* as a factor that affects the DLOM.

The expected investment holding period is also expressly stated to affect the DLOM in Revenue Ruling 77-287.⁴ It is also a factor considered in the restricted stock studies, the pre-IPO studies, the option-pricing studies, and the discounted cash flow DLOM models.

This factor is frequently associated with the DLOM because:

1. it has been clearly measured in empirical studies,
2. it is intuitive, and
3. it encompasses a variety of other intuitive factors.

In Table 1, the size of the DLOM is directly related to the expected investment holding period. As the investment holding period increases, so does the DLOM.

The expected investment holding period for a privately held company is clearly an important consideration in the selection of the DLOM. One challenge for the valuation analyst is to accurately assess the expected investment holding period of privately owned stock. Valuation analysts can estimate the expected investment holding period based on consideration of:

1. put rights,
2. the prospect of an IPO or sale of the business,
3. the size of the subject interest, and
4. any contract-specific transferability restrictions.

Table 1
Emory Studies for 1980 to 2000
(After a 2002 Revision)
Price Discounts Versus the Amount of
Time Between the Transaction and the IPO

Number of Days	Price Discount		Transaction Count
	Average	Median	
0-30	30%	25%	18
31-60	40%	38%	72
61-90	42%	43%	162
61-120	49%	50%	161
121-153	55%	54%	<u>130</u>
Total			<u>543</u>

Source: Institute of Business Appraisers Annual National Conference, June 2, 2003.

Put Rights

In some situations, company shareholders will possess certain “put” rights. These put rights allow the shareholders to resell their shares to the company, based on certain specified provisions. For example, in the case of an employee stock ownership plan (ESOP), the put right may allow all of the ESOP participants to resell their shares to the company upon the termination, retirement, death, or disability of the ESOP participant, at the then fair market value.

The existence of a put option provides a market for shares of privately owned stock, and such a put option would decrease the appropriate DLOM, all else equal.

However, the existence of a put option has little value if the subject company is not expected to have the ability to meet its stock redemption obligation.

When a privately held company has a put option, the ability of the company to acquire shares that are “put” to the company is typically an important factor to consider. The put option may not actually provide liquidity to a shareholder in a company (1) that generates negative operating cash flow or (2) that has little debt capacity.

Prospect of a Public Stock Offering or a Sale of the Overall Business

Another obvious liquidity event for a noncontrolling shareholder in a privately owned company is an IPO or a sale of

the overall business. Here, the greater the imminence of an IPO or business sale, the lower the appropriate DLOM, all other factors being equal.

Among other factors, the imminence of an IPO or sale depends on the size of the business, the industry the business competes in, and the attitudes of the company owners. A likely IPO/sale candidate may be characterized by the following factors:

1. The company maintains a strong balance sheet.
2. The company enjoys consistent and projected profitability.
3. The company operates in an industry under consolidation.
4. The company is actively marketed with the assistance of a business broker.

Of course, like marketability itself, this factor is not an absolute proposition. That is, a company should not be characterized as “likely” or “unlikely” to complete an IPO or sale. Instead, there is a spectrum of liquidity event possibilities that exist.

Even though a company may be a strong candidate for a liquidity event transaction, a noncontrolling equity owner has no assurance (and no influence) that a control event transaction will occur. Both the potential for a liquidity event and the risks of completing a liquidity event affect the expected holding period of a stock.

The Size of the Ownership Interest

The size of the privately owned interest will also affect the expected holding period. There is empirical evidence that larger blocks of stock are associated with a larger DLOM.

Larger blocks of stock are typically harder to sell. This is because the pool of potential buyers that can afford an asset decreases as the price of the asset increases. That is, more investors can afford (in terms of price, and in the context of their investment objectives) to acquire a \$100,000 ownership interest than a \$10 million ownership interest.

Contractual Transferability Restrictions

The restricted stock DLOM studies present a multitude of factors that affect the DLOM for privately owned companies. Certain factors purported to affect the DLOM appear more often than others. For example, many of the restricted stock studies agree that company size, block size, and dividends all have an effect on the DLOM. However, these DLOM studies are limited because they can only consider the factors that they can measure.

“ . . . the existence of a put option has little value if the subject company is not expected to have the ability to meet its stock redemption obligation.”

There are specific factors that affect privately owned companies that are not present (and therefore not measurable) in the various restricted stock studies. These transferability restriction factors are contractual restrictions (such as a shareholder agreement, right of first refusal, buy-sell agreement, and the like).

These contractual restrictions can severely limit the marketability of a noncontrolling ownership interest in a privately owned company. These factors, by their nature, are very case-specific.

The following list presents the contractual restrictions that may affect the size the DLOM:

1. buy-sell agreements
2. shareholder or partnership agreements
3. rights of first refusal
4. any other contractual transferability restrictions

These contractual restrictions can severely limit the marketability of the privately owned equity interest. The more restrictive the agreement or provision, the greater the appropriate DLOM, all else equal.

“These transferability restriction factors are contractual restrictions (such as a shareholder agreement, right of first refusal, buy-sell agreement, and the like).”

The Subject Company Risk

The third factor that affects application of the DLOM is the subject company risk. The restricted stock DLOM studies and the option pricing DLOM studies both conclude that the size of the DLOM is directly related to the stock price volatility (one measure for risk).

The studies are also consistent in attributing company size (another measure for risk) with the DLOM size. For example, the McConaughy, Cary and Chen restricted stock study pointed out, “There are three factors that remain significant: size, stability of revenue growth, and stock price volatility. These three factors clearly reflect the riskiness of investing in a company.”⁵

And, each of these three factors relates directly to the subject company risk.

Valuation analysts generally agree that a large company is a “safer” investment than a similar small company, all other factors being equal. This conclusion is illustrated by comparing the required rates of return on large-capitalization companies to small-capitalization companies.

Ibbotson Associates makes this comparison in *SBBI Valuation Edition*, 2006 Yearbook (SBBI). According to *SBBI*, “One of the most remarkable discoveries of modern

finance is that of a relationship between firm size and return. The relationship cuts across the entire size spectrum but is most evident among smaller companies, which have higher returns on average than larger ones. . . . Small-capitalization stocks are still considered riskier investments than large company stocks. Investors require an additional reward, in the form of additional return, to take on the added risk of an investment in small-capitalization stock.”⁶

Large companies are perceived as safer investments than are small companies. This is because greater earnings typically enable a company:

1. to withstand downswings in the economy and subject company industry and
2. to capitalize on growth opportunities that require borrowing capacity or cash.

Factors in addition to size can also affect subject company risk. Every company is unique, and there is no one list that can encompass the wide range of potential risk factors.

However, the following list comprises some of the more common company-specific factors that affect subject company risk:

- historical financial ratios
- historical earnings trends/volatility
- management depth
 - product line diversification
 - geographic diversification
 - market share
 - supplier dependence
 - customer dependence
 - deferred expenditures
 - lack of access to capital markets

“. . . the size of the DLOM is directly related to the stock price volatility. . . .”

SUMMARY AND CONCLUSION

The acceptability of selecting a DLOM based solely on the average DLOM reported in the empirical studies has significantly decreased in the last decade. Accordingly, a thorough understanding of how the subject interest compares to the interests analyzed in the various empirical DLOM studies is important to a defensible DLOM analysis.

If the subject company or subject security has an expected holding period of one year or less, then it may be more meaningful to place more emphasis on the DLOM results from the post-1990 restricted stock studies than the pre-IPO studies.

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Alternatively, if a public market or liquidity event is not expected to occur for many years, then the results from pre-IPO studies may be more meaningful.

In addition to comparing the subject interest to the empirical DLOM studies, the subject interest may warrant an upward or downward adjustment relative to the selected benchmark. As reiterated throughout this discussion, the most important company-specific and security-specific factors to consider are:

1. historical and expected dividend payments,
2. expected investment holding period, and
3. the subject company risk.

The importance of analyzing the subject company relative to the empirical DLOM studies is illustrated by the wide range of price discounts observed within each empirical DLOM study.

The wide range of observed discounts illustrates that a multitude of company-specific and security-specific factors affect stock pricing and the size of the DLOM.

Notes:

1. See, for example, *Lappo v. Commissioner*, T.C. Memo 2003-258, *Peracchio v. Commissioner*; T.C. Memo 2003-280; *Kelley v. Commissioner*, T.C. Memo 2005-235; *McCord v. Commissioner*, 120 T.C. No. 13 (2003), and *Kohler, et al. v. Commissioner*, T.C. Memo 2006-152.
2. *Mandelbaum, et al. v. Commissioner*, T.C. Memo 1995-255.
3. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th edition, (New York: McGraw-Hill 2000), p. 417.
4. According to Rev. Rul. 77-287, Section 6.02, "the longer the buyer of the shares must wait to liquidate the shares, the greater the discount."
5. Daniel L. McConaughy, David Cary, and Chao Chen, "Factors Affecting Discounts on Restricted Stock," *Valuation Strategies*, November/December 2000, p. 46.
6. Ibbotson Associates, *SBBI Valuation Edition*, 2006 Yearbook (Chicago: Ibbotson Associates, 2006), pp. 129 and 160.

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