Business Valuations for Estate and Gift Tax Purposes

Valuing a closely held business is a complex task, but the IRS has enumerated factors to consider when appraisals are for determining transfer taxes.

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Many factors must be considered when applying the chosen valuation techniques in an engagement to estimate the value of a closely held business for gift or estate tax purposes. This article discusses some of those factors, focusing on tying the points discussed to an authoritative source of tax guidance. The article is not intended to be a nuts-and-bolts guide to preparing a business valuation. A large, and ever growing, number of other resources seek to fill that niche.

The top federal estate tax has fallen from 55% in 2001 to 40% for 2016. During this same period, the estate tax exemption increased from $675,000 to $5.45 million. Many taxpayers have benefited from the increase in the estate tax exemption, as it puts smaller estates out of the grasp of the estate tax. For taxpayers with taxable estates, the decline in the top tax rate provides some relief—at least for now. The estate tax rate is a favorite lever for legislators seeking favor from either those who are subject to the tax or those that may never be subject to the tax. Careful estate tax planning will always consider the potential future changes in estate tax rules and regulations.

Know the terrain

Understanding the structure of the Internal Revenue Code is essential to navigating it and understanding its many cross-references. In many instances, rules, definitions, and exceptions within the Code apply only to a specific part of the Code.

The Internal Revenue Code is Title 26 of the United States Code (U.S.C.). It contains 11 subtitles which include thousands of sections. Subtitle B, sections 2001 through 2801, covers estate and gift taxes in five chapters, chapters 11 through 15:

- Chapter 11—Estate Tax (Sections 2001 through 2210).
- Chapter 12—Gift Tax (Sections 2501 through 2524).
- Chapter 13—Tax on Generation-Skipping Transfers (Sections 2601 through 2664).
- Chapter 14—Special Valuation Rules (Sections 2701 through 2704).
- Chapter 15—Gifts and Bequests From Expatriates (Section 2801).

Chapter 11 is mostly of interest to estate planning and tax professionals. For valuation professionals, this chapter includes the definition of the value of a decedent's gross estate as being the value of all of his or her property as of the date of death (Section 2031(a)).

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The chapter also provides a brief discussion of the valuation of unlisted stock and securities (Section 2031(b)).

Chapter 12 is a rather short chapter, made up of only 19 sections. Within this chapter is the definition of taxable gifts (Section 2503(a)). As with Chapter 11, most of this section is of interest to estate planning and tax professionals.

The operating agreements of many closely held companies include restrictions that should be disregarded under this section.

Chapter 13 establishes the rules on transferring wealth to family members who are at least one or more generations removed from the individual making the transfer (e.g., grandchildren).

Chapter 15 includes only one section (Section 2801), which establishes the rules for determining and paying tax on the transfer of assets by a U.S. citizen who has relinquished citizenship or by a long-term resident of the U.S. who is no longer lawfully a U.S. resident.

For valuation purposes, Chapter 14 (Special Valuation Rules) is of greatest interest. It contains Sections 2701 through 2704. These sections are not long, and every word can be read in a short sitting.

Section 2701 was enacted as part of the Omnibus Budget Reconciliation Act of 1990 to introduce specialized valuation rules that pertain to transfers of interests in corporations or partnerships. To avoid the implications of Section 2701, a family limited partnership (FLP) needs to ensure, among other things, that all partnership allocations and distributions are done pro-rata based on the partners' ownership interests.

Section 2702 includes special valuation rules that pertain to transfers in trusts. Under Section 2702, retained interests in trusts are valued at zero unless they meet the section's definition of a qualified interest. Qualified interests are valued using valuation tables described in Section 7520.

According to Section 2703, property should be valued regardless of any options or agreements to acquire or use the property at a price less than the property's fair market value. Section 2703 does not apply to any option, agreement, right, or restriction that:

1. Is a bona fide business arrangement.
2. Is not a device meant to transfer the property at less than full consideration.
3. Has terms comparable to similar arrangements made at arm's length.

Any restriction that meets the three safe-harbor requirements is considered in determining the value of the interest.

The operating agreements of many closely held companies include restrictions that should be disregarded under this section. Appraisers should take care not to use such restrictions to support a reduction in the value of a business interest.

Section 2704 covers the treatment of lapsed voting or liquidation rights in a corporation or partnership. This section states that if an individual holds the right immediately before the lapse and members of the individual's family have control of the entity before and after the lapse, the lapse should be treated as a gift transfer or a transfer includable in the gross estate of the decedent, whichever is applicable.

Section 2704(2) defines the transfer amount as the excess of the value of all interests held by the individual immediately before the lapse, determined as if the rights were non-lapsing, over the value of such interests immediately after the lapse. Section 2704(b) restricts appraisers from considering any restrictions on liquidation when the transferor or members of the transferor's family have control over the entity before the transfer.

In fulfilling its role in administering the tax laws, the IRS must take the specifics of these laws and translate them into detailed regulations, rules, and procedures. The Office of Chief Counsel of the IRS fills this crucial role by producing several different kinds of documents and publications that provide guidance to taxpayers.

This guidance can take the form of regulations, revenue rulings, revenue procedures, private letter rulings, technical advice memorandums, notices, and announcements. Different forms of guidance carry different weights. For instance, a revenue ruling is the IRS's interpretation of the Code while a private letter ruling is issued to a taxpayer in response to written request from a taxpayer. Revenue rulings can be relied on by all taxpayers and IRS personnel, while private letter rulings cannot.

Rev. Rul. 59-60[1]

No discussion of business valuations for estate and gift tax purposes would be complete without some discussion of Rev. Rul. 59-60. Although it was issued over a half century ago, Rev. Rul. 59-60 provides essential guidelines which must not be overlooked when performing a valuation of the stock of a closely held company for estate or gift tax purposes. Rev. Rul. 68-609[2] later stated that the methods and factors outlined in Rev. Rul.

59-60 are equally applicable to the valuation of business interests of any type and also for income and other tax purposes as well. A quality valuation report should mention that the factors listed in Rev. Rul. 59-60 were considered in the appraisal process.

Eight factors. An important part of Rev. Rul. 59-60, and the part that is often quoted in valuation reports, is section 4.01 which lists the eight factors that should be considered when performing a valuation of an interest in a closely held company for estate or gift tax purposes:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general, and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earning capacity of the company.
5. The dividend-paying capacity.
6. Whether the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

Most practitioners would probably consider these factors to be obvious ones to consider in performing a business valuation. However, section 4.02 expands upon the list and provides specific guidance regarding them.

Enterprise history. Section 4.02(a) states that an analysis of the history of the enterprise should include a discussion of the company's revenue growth, stability, diversity of operations, "and other facts needed to form an opinion on the degree of risk involved in the business." The analysis should become more detailed closer to the valuation date because recent events are "of the greatest help in predicting the future." A study of gross and net income, and of dividends "covering a long prior period is desirable." Section 4.02(a) continues with a description of the business history that should be studied, including:

- The nature of the business.
- Products and services.
- Operating and investment assets.
- Capital structure.
- Plant facilities.
- Sales records and management.

Section 4.02(a) explicitly states that past events that are unlikely to occur again should be discounted because "value has a close relation to future expectancy."

Industry and economic factors. As expected, section 4.02(b) explains that a sound appraisal must consider the current and prospective economic conditions, both in the national economy and the industry in which the company operates. Most quality appraisal reports include clearly marked sections containing these discussions. Beyond the economic and industry discussions suggested, section 4.02(b) goes on to describe some very company-specific factors that should be considered, including a detailed consideration of the competition the company faces, key employees, and succession planning factors.

Although these company-specific factors are included in section 4.02(b)'s discussion of economic and industry factors, most appraisers would discuss these factors in a separate section of their report, generally in the same section as the company-specific factors from section 4.02(a). It is important to note that there is no guidance regarding the organization of the valuation report. A report should include all the required discussions and be easy for the reader to understand.

Financial condition. Section 4.02(c) lists the historical balance sheet data that should be obtained and analyzed. This section suggests that annual comparative balance sheet data be obtained for "two or more years" prior to the valuation date as well as for the month-end preceding the valuation date, "if corporate accounting will permit." Clearly, modern accounting systems offer an advantage over the systems available in 1959. Thus, it is not uncommon to see valuation reports that include a balance sheet as of the valuation date. The data analyzed should include liquidity, working capital, fixed assets, long-term debt, and non-operating assets.

Also mentioned in this section is an analysis of the company's capital structure including a determination of the rights and privileges of the various classes of stock including voting rights, dividends, and liquidation preferences. Although only warranting one sentence in Rev. Rul. 59-60, allocating a company's total equity value to the various classes of stock in today's complex capital structures can represent a significant step in a valuation engagement. Rev. Rul. 83-120[3] amended Rev. Rul. 59-60 by specifying additional factors that should be considered in valuing the preferred stock of a closely held corporation. According to section 4.01 of Rev. Rul. 83-

1 1959-1 CB 237.
2 1968-2 CB 327.
3 1983-2 CB 170.

120, "[i]n general, the most important factors to be considered in determining the value of preferred stock are its yield, dividend coverage, and protection of its liquidation preference."

Profit and loss data. Rev. Rul. 59-60, section 4.02(d) lists the historical profit and loss data that should be obtained and analyzed. This section suggests that detailed profit and loss statements should be obtained for a representative period prior to the valuation date, "preferably five or more years." The statements should include:

- Gross income.
- Operating expenses.
- Interest expense.
- Depreciation expense.
- Officer's compensation.
- Contributions.
- Taxes.
- Net income.

Also mentioned are dividends and a reconciliation of retained earnings. The income statement data should be of sufficient detail to allow an appraiser to identify recurring and nonrecurring items of income and expense and operating versus non-operating income and expense. Investments necessary for business expansion must be considered when estimating the dividend-paying capacity of the business. The identification of potential excess compensation is mentioned briefly without suggesting how that might affect value. This section explicitly states that while prior earnings are usually the most reliable guide to future expectations, resorting to five- or ten-year averages may result in an incorrect valuation when there is a clear upward or downward trend in net income.

Ability to pay dividends. Section 4.02(e), relating to dividend-paying capacity, is relatively short compared to the other sections. This section does note that dividend paying capacity should be given more consideration than dividends actually paid in the past. As mentioned in Section 4.02(d), the necessity of retaining a portion of the company's profits to fund continuing operations must be considered.

Importantly, a discussion of the elements of control and of income tax planning also arise in this section. Controlling shareholders can make salary and bonus decisions that will affect taxable income and dividend-paying capacity. "It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors."

Allocating a company's total equity value to the various classes of stock in today's complex capital structures can represent a significant step in a valuation engagement.

Goodwill. Section 4.02(f) discusses the potential for goodwill or other intangible value. This section contains language that states that it may not be possible to make a separate appraisal of the tangible and intangible assets of a business and that any intangible value that does exist will be captured in the value of the entity as a whole even though the intangible value is not identified and valued separately. Rev. Rul. 65-193 modifies this section to delete this language and instead states: "[t]he instances where it is not possible to make a separate appraisal of the tangible and intangible assets of a business are rare and each case varies from the other. No rule can be devised which will be generally applicable to such cases."[4]

Past stock sales. Section 4.02(g) addresses past sales of the stock being valued. While past sales of the company's stock can be indicative of fair market value, appraisers must determine if the past sales could have been distressed sales which would not represent an arm's-length transaction. The definition of fair market value should be considered as part of this analysis before relying on the past sale as an indication of value.

This section states that minority interests in a closely held company are more difficult to sell than a similar-sized interest in a listed stock and that a controlling interest may justify a higher value. Remember that Rev. Rul. 93-12 states that corporate control within a family is not considered when transferring minority interests for estate and gift tax valuation purposes.

Comparable companies. Section 4.02(h) cites IRC Section 2031(b) as saying, in effect, that when valuing the stock of a closely held company, an appraiser should consider the value of the listed securities of companies in a similar line of business. However, section 4.02(h) goes on to say that if sufficient listed companies cannot be found, other comparable companies that have stocks traded on the over-the-counter market may also be used.

When selecting comparable companies, a valuation analyst must ensure that wherever these stocks are traded, whether on an exchange or over-the-counter, that they be traded in an active market. Section 4.02(h) states that companies with capital structures that include preferred stock or debt should not be

4 Rev. Rul. 65-193, 1965-2 CB 370.
5 1977-2 CB 319.

considered comparable to companies having only common stock outstanding. Valuation analysts can improve comparability in such situations by applying invested capital multiples rather than equity multiples.

Rev. Rul. 77-287[5] lists other factors that should be considered in conjunction with the factors in section 4 when estimating the value of restricted stock.

Weighing factors. Rev. Rul. 59-60 section 5 addresses the relative weight that should be accorded to the factors in section 4. Section 5 does not go into the factor-by-factor detail of section 4; however, this section does state that earnings may be the most important factor in some cases, such as when valuing the stock of a company that sells products or services, while asset values may be more important in others, such as when valuing an investment or holding company. This section also goes to some length to stress that the value of a closely held investment or real estate holding company is closely related to the value of the assets underlying the stock.

Although contrary to some opinions, this section states, "For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, regardless of whether family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity."

Section 6 of Rev. Rul. 59-60 briefly discusses capitalization rates. Most valuation analysts would agree with the language that states that one of the most difficult problems in performing a valuation is the selection of an appropriate capitalization rate. Although Rev. Rul. 59-60 pre-dates the market data resources available today, it does state that there is no simple solution and that the nature of the business, the risk involved, and the stability or irregularity of the earnings must be considered.

Section 7 seems out of place, as it backtracks to again discuss the weighting of the factors described in section 4. Section 7 explains that there is no way to assign mathematical weights to the factors to derive fair market value and certainly taking an average of several factors, or valuation methods, would be inappropriate. In the author's experience, most appraisers do reconcile the value conclusions from several valuation methods by applying some weighting based on the relative confidence they have in each method. As stated in this section, simply taking the average of several conclusions would not be supportable except if the valuation analyst believes each method is equally reliable.

Shareholder agreements. Section 8 of Rev. Rul. 59-60 discusses the valuation of stock that is subject to agreements restricting its sale or transfer. These agreements must be considered when estimating value for estate or gift tax purposes but it is always necessary to consider the relationship of the parties and other material facts. This section warns of the possibility that such agreements may not be bona fide business arrangements but instead a device to pass the decedent's shares for less than adequate and full consideration. The topic of this section seems related to the provisions of Section 2703 discussed above.

Fair market value

An important element of any valuation is the concept of standard of value. For any tax-related valuations, the applicable standard of value is fair market value. Section 2 of Rev. Rul. 59-60 provides that all valuations must be made in accordance with the Internal Revenue Code and federal estate and gift tax regulations. As a definition of fair market value, Rev. Rul. 59-60 offers:

> the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

This is the definition that is typically cited in valuation reports, whether for estate tax purposes or gift tax purposes. However, Rev. Rul. 59-60 refers to Reg. 20.2031-1(b) (estate tax) and Reg. 25-2512-1 (gift tax) for support of this definition.

Reg. 20.2031-1 gives a specific definition of fair market value for estate tax purposes:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includable in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Reg. 25.2512-1 gives a different definition of fair market value for gift tax purposes:

> The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the

> sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

These two definitions are nearly identical but still different. The first two sentences of the gift tax definition refers to "value" but not "fair market value." Not until the last sentence of the definitions do they become identical. Knowing this, why do most valuation reports use the Rev. Rul. 59-60 definition when it is only a paraphrasing of the actual Treasury Regulations?

Alternative definition. The International Glossary of Business Valuation Terms, which has been adopted by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and The Institute of Business Appraisers, includes yet another definition of fair market value:

> the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms [sic] length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. [NOTE: In Canada, the term "price" should be replaced with the term "*highest price*".]

(Emphasis and bracketed final sentence in original.)

This definition could be useful in some situations, such as when a buy/sell agreement stipulates a fair market value standard, but should not be quoted in any report for tax purposes.

Penalties

The IRC provides penalties for inaccurate appraisals. Taxpayers, appraisers, and tax preparers can be penalized for using an appraisal of property in connection with a tax return or claim for refund. Taxpayer penalties may be imposed if the claimed value of the property results in a substantial valuation misstatement, a substantial estate or gift tax valuation misstatement, or a gross valuation misstatement.

If a gift meets the adequate disclosure requirements, the three-year statute of limitations starts running when the gift tax return is received by the IRS.

A substantial valuation misstatement is defined in Section 6662(e) as the claimed value of the property being 150% or more than the amount determined to be the correct value of the property. Valuation misstatements which exceed the correct value of the asset are typically seen in charitable contributions where the taxpayer may be seeking an unreasonably high deduction.

A substantial estate or gift tax valuation misstatement is defined in Section 6662(g) as a value claimed on a tax return that is 65% or less than the amount determined to be the correct value of the property. This leaves quite a margin of error before the penalty applies.

A gross valuation misstatement is defined in Section 6662(h) as larger misstatements than those defined in Sections 6662(e) and (g). A misstatement under Section 6662(e) becomes a gross valuation misstatement when the claimed value of the property is 200% or more than the amount determined to be the correct value of the property. A misstatement under Section 6662(g) becomes a gross valuation misstatement when the value claimed on a tax return is 40% or less than the amount determined to be the correct value of the property.

Taxpayer penalties under these sections are 20% of the underpaid tax attributable to a substantial valuation misstatement and 40% of the underpaid tax attributable to a gross valuation misstatement.

There are limitations to these penalties. Penalties for these valuation misstatements only apply when the portion of the underpayment attributable to the valuation misstatement exceeds $5,000.

Individuals who prepare appraisals are subject to similar penalties under Section 6695A if that person knows or should have known that the appraisal would be used in connection with a tax return or claim for refund. Penalties under this section range from the greater of 10% of the misstatement or $1,000, up to 125% of the gross income received by the person preparing the appraisal. This section does not define "person" and the words "appraiser," "qualified appraiser," or "qualified appraisal" are never used. The penalties under this section apparently have the widest possible reach and are not limited by a practitioner's title or specific business function. This section provides an exception, which states that no penalty will be imposed if the person preparing the appraisal can establish to the satisfaction of the Secretary of the Treasury that the value in the appraisal was "more likely than not the proper value."

6 2006-2 CB 902.

7 Pratt, Reilly, and Schweihs. *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th Ed. (McGraw-Hill, 2000).

8 TCM 1995-255.

9 Department of the Treasury, Internal Revenue Service, IRM 4.48.4, Engineering Program, Business Valuation Guidelines 4.1.1 (issued 7/1/2006).

Adequate disclosure of gifts

Reg. 301.6501(c)-1 addresses the adequate disclosure of gifts on a gift tax return. If a gift meets the adequate disclosure requirements, the three-year statute of limitations starts running when the gift tax return is received by the IRS. After the three years passes, the IRS may not reopen the return for gift tax purposes. However, the gift may be revalued for estate tax purposes.

Reg. 301.6501(c)-1(f)(2) provides a list of the information that must be reported on the gift tax return (or in a statement attached to the return) in order for the gift to be adequately disclosed. The required information includes:

1. A description of the transferred property and any consideration received by the transferor.
2. The identity of, and relationship between, the transferor and each transferee.
3. If the property is transferred in trust, the trust's tax identification number, a description of the terms of the trust, or a copy of the trust.
4. A detailed description of the method used to determine the fair market value of the property transferred.
5. A statement describing any position taken that is contrary to any proposed, temporary, or final Treasury regulations or revenue rulings published at the time of the transfer.

Reg. 301.6501(c)-1(f)(3) states that in lieu of the information required under paragraph (f)(2), the donor may submit an appraisal of the transferred property.

Qualified appraiser and qualified appraisal

Although these terms are not defined within the estate and gift tax sections of the Code, Section 170, which addresses charitable contributions for income tax purposes, does provide guidance that practitioners within the estate and gift arena should be aware. According to Section 170(f)(11)(E)(i):

> The term "qualified appraisal" means, with respect to any property, an appraisal of such property which—
>
> (I) is treated for purposes of this paragraph as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and
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> (II) is conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed under subclause (I).

Although subclause I leaves plenty of room for an expanded definition, subclause II simply states that an appraisal is a "qualified appraisal" if it is conducted by a qualified appraiser in accordance with generally accepted appraisal practice. Section 3.02(2) of Notice 2006-96,[6] which provides guidance relating to the new terms in the Pension Protection Act of 2006, says that an appraisal will be considered as having been conducted in accordance with generally accepted appraisal standards, "if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP")...."

Section 170(f)(11)(E)(ii) defines "qualified appraiser" as an individual who:

> (I) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary,
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> (II) regularly performs appraisals for which the individual receives compensation, and
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> (III) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.

Section 170(f)(11)(E)(iii) indicates that an individual is not a qualified appraiser unless the individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal and who has not been prohibited from practicing before the Internal Revenue Service during the three-year period ending on the date of the appraisal.

The pre-IPO studies indicate a higher average discount than the restricted stock studies.

Discount for lack of marketability

Marketability is defined as "the ability to convert the business ownership interest (at whatever ownership level) to cash quickly, with minimum transaction and administrative costs in so doing and with a high degree of certainty of realizing the expected amount of net proceeds."[7]

A discount for lack of marketability is necessary to reflect the fact that a minority interest in a closely held business is more difficult to sell than publicly traded stock. The market for closely held shares is limited. A person who owns shares of publicly traded stock can place an order to sell with a broker and have cash in three days. Such is not typically the case with investments in closely held companies. This lack of liquidity is an element of the marketability discount. In addition to this lack of liquidity, other factors are reflected in, and affect the size of, the marketability discount.

The fair market value standard itself, and Rev. Rul. 59-60 section 4(g) supports the notion of including a discount for lack of marketability (DLOM) in the valuation of minority interests. While comfort can be taken in knowing that the taking of a DLOM is widely accepted, the work begins when estimating the appropriate discount.

Empirical data regarding marketability discounts comes from two general types of studies: pre-IPO studies and restricted stock studies. Both types of studies deal with transactions of stock that have known marketability events; they have achieved marketability either by going public or by satisfying a known restriction period.

The pre-IPO studies compare the prices of private transactions relative to the prices of subsequent public offerings in the stock of the same companies. The most extensive of these studies was conducted by John Emory, with eight studies covering the period 1980 through 2000. The median marketability discounts indicated by the Emory studies ranged from 40% to 66%. The overall median discount over the 20-year period of the studies was 48%.

Within the restricted stock study category, a variety of studies have been performed from 1966 to 1998. Restricted stock studies analyze transactions involving stock that is identical in all respects to the freely traded stock of a public company, except that it is restricted from trading on the open market for a certain period. These studies found a range of discounts between 13.0% and 45.0% and an overall median and average discount of 31.0% and 29.0%, respectively. The median discount has fallen since 1990 when the SEC began changing certain registration and holding requirements, which improved the liquidity of restricted stock. The median discount using just studies done prior to these changes was 33.0%.

The pre-IPO studies indicate a higher average discount than the restricted stock studies. This difference can be attributed to the fact that the pre-IPO offering transactions occurred when there was not yet any established secondary market for the subject stock. This is similar to an interest in a closely held company, which has no established secondary market. Unlike the companies in the pre-IPO studies, a closely held company has no near-term public offering or other equivalent liquidity event on the horizon. This would indicate a higher discount for an interest in a closely held company than that observed in these studies.

The *Mandelbaum* factors

In the landmark 1995 case of *Mandelbaum*,[8] the Tax Court provided additional guidance to be considered when determining a discount for lack of marketability (DLOM). In deciding the case, in which the discount for lack of marketability was the sole issue, Judge David Laro provided a list of factors he believed should be considered in determining an appropriate discount for lack of marketability. The ten factors noted by the court were as follows:

1. Private vs. public sales of the stock.
2. Financial statement analysis.
3. Company's dividend policy.
4. Nature of the company, its history, its position in the industry, and its economic outlook.
5. Company's management.
6. Amount of control in transferred shares.
7. Restrictions on transferability of stock.
8. Holding period for stock.
9. Company's redemption policy.
10. Costs associated with making a public offering.

While any of these factors overlap with other portions of a valuation analysis (Rev. Rul. 59-60 factors), no discussion of a potential DLOM is complete without mentioning the *Mandelbaum* case and these ten factors. The most significant of these factors should be included in an expanded discussion including how they increase or decrease the potential DLOM.

There are other more quantitative methods for determining a DLOM. The quantitative marketability discount method (QMDM) links the DLOM to the difference between enterprise-level and shareholder-level cash flows. Option pricing models such as David Chaffee's Black-Scholes-Merton based model, Francis Longstaff's upper-bound lookback model, and John Finnerty's Asian look-back put option model are all widely used to estimate a DLOM. It is not unusual to see valuation reports that apply three or more of these methods to estimate a DLOM. Valuation reports should apply specific company and market data and not rely on prior court decisions or the general averages of multi-year studies.

Conclusion

The valuation report attached to the estate or gift tax return is the taxpayer's best opportunity to persuade the IRS that the return should be accepted as filed. The IRS business valuation guidelines[9] state that "the primary objective of a valuation report is to provide convincing and compelling support for the conclusions reached." As outlined in this article, the IRS has provided a significant amount of guidance that can be used to assure that valuations meet IRS expectations. A well-prepared valuation report that supports the conclusion of value in sufficient detail is the best way to avoid follow-up inquiries or challenges by the taxing authorities. ■