



## **MINORITY DISCOUNTS**

### **DEFEND THEM OR LOSE THEM**

BY:

GERALD BARNEY, MS, CSBA, CMEA

MELISA SILVERMAN, JD, CMEA, SBA

## MINORITY DISCOUNTS – DEFEND THEM OR LOSE THEM

Financial professionals involved with wealth management need to be aware of the effects of court cases relating to valuation of minority interests in small businesses and related securities. Cases brought to the Tax court in recent years have shed light on the relatively obscure subject of discounted values caused by reduced marketability and control for minority interests. This is an issue that is faced by professional advisors regarding gift and estate taxes, and for financial planning. The cases will be pointed out in this article.

Prior to these cases, appraisers generally treated valuation of such discounts as a relatively minor adjunct to the valuation of the basic (majority) position. Many either used “industry standards” for marketability discounts of, say, 35% without support, or they attempted to support these values with statistics from studies of restricted stock of public companies (which can be sold, usually at a discount, from their unrestricted brethren, and by IPO studies of stock values before and after the Initial Public Offering. The courts have virtually all rejected such valuations in the case of closely held securities, and laid down some principles which, if adhered to in appraisals, should significantly limit the chances of litigation. And, if litigated it should dramatically enhance the chances of winning.

### VALUATION PRINCIPLES

All appraisals are a defensible opinion of value, prepared by an expert, for an ownership interest. Such an ownership interest is often referred to as a “bundle of rights.” Normally ownership in fee contains the most valuable bundle of rights, and lesser forms such as ownership of a security interest, lease, license, or other such instrument will reduce the bundle of rights – and hence the value. Further, restrictions on marketability or control of such minority interests results in a reduction of value.

If the asset to be valued is a minority interest, and/or if it is subject to restricted marketability, and/or lack of control, appropriate discounts to value must be applied. Over the years, many appraisers have adopted policies that separated the lack of control

discount from the lack of liquidity or marketability discount. However, this appears to be a difference without a distinction. All discounts from value appear to be, in the end, evidence of impairments in marketability. The fact that such discounts, even if treated as separate discounts, are multiplicands which are multiplied by each other to derive a final discount figure illustrates this point.

Though the appropriateness of applying such discounts in these situations has been universally accepted by the IRS and the courts, recent court decisions have shown a fair amount of disagreement over the means of quantifying the appropriate discounts. (IRS Revenue Ruling 77-287 deals with marketability discounts for “*restricted securities*,” but it is silent on “*exempted securities*,” which make up the vast majority of privately held securities. Both are defined and described in the Securities Act of 1933.) The cases indicate a complete analysis is required.

To quantify the “marketability discount,” because of a lack of available specific data, some appraisers have been relying on two sources of data from public company transactions; Initial Public Offering Studies, and Restricted Stock Studies to defend their discount opinion. The “standard” discount often derived from these studies is typically between 30% to 40%. Three cases against the Commissioner in 2003 found that such studies, based upon data from public companies, were not sufficient basis to value closely held private (exempt and unregistered) ownership. Upon a deeper look the reasons are fairly obvious:

- Initial Public Offering Studies (IPO) show the difference in the price of a stock before the offering and after, and an appraiser may attempt to infer that this is direct evidence to support a marketability discount for an exempt security. This is erroneous for the following reasons:
  - Stock values of privately held companies typically are based upon *investment value* – that is, an investor will be interested in both the current return, and the amortization factor (risk abatement factor) which indicates

how long it will take to recover the initial investment. This is necessary because of the high degree of illiquidity of non-public securities.

- The IPO price, on the other hand, reflects a *speculative value* – that is, the investor is looking mainly towards price appreciation. By its nature once publicly traded, the stock should have high liquidity, so recovery of the investment is not an investment concern. Thus, this study is relevant only to companies anticipating an IPO. Unfortunately these companies represent less than 1% of the companies extant in the U.S.
- Restricted Stock Studies deal with stocks of public companies that have been temporarily restricted from sale for two years (later for one year) in the public markets (usually by virtue of securities regulations under Rule 144). Nonetheless, there is no prohibition in selling these securities in private transactions where they usually sell at an average of 30% or so less than publicly traded stock. But these are applicable only to publicly traded stocks that have only a *temporary* restriction from public markets, and not on the general "permanent" illiquidity problem faced by small privately held companies which would make them far less marketable.

Control discounts, (or more appropriately control-based marketability discounts) for small privately held companies are magnified in comparison with publicly held companies for a simple reason – in privately held companies the only practicable way to recover the investment is liquidation (sale) of the company. Without control, an investor does not have the right to exercise this option. Thus minority interests in closely held companies are very difficult to sell. In practice, in the past appraisers have often attempted to base discounts for lack of control on control premium studies of public companies. The two are not the same at all.

The case of Mandelbaum v. Commissioner, T.C.M 1995-255 determined that use of irrelevant data is unacceptable, and sets forth some basic factors which might comprise

the discount, but specified that this list was not exclusive, and other factors may (and should) apply as the situation dictates. It basically states that a complete analysis must be done which is relevant to the subject. The factors listed to be evaluated included but were not limited to:

- Private vs. public sales of stock
- Financial statement analysis
- Dividend policy
- Nature of the company, history, position in the industry and economic outlook
- Management
- Amount of control in transferred shares
- Restrictions on transferability of stock
- Company's redemption policy
- Costs associated with making a public offering.

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#### **ASSESSING EFFECTS ON SMALL VERSUS LARGE COMPANIES**

To put this in perspective the following table shows the number of businesses in each group by employee size extracted from County Business Patterns, 2005, published by the Bureau of Census, for the USA (total of 6-million companies). It shows the overwhelming proportion of small (SEC exempt) companies.

|                         |       |
|-------------------------|-------|
| Less than 10 employees  | 79.0% |
| Less than 20 employees  | 90.0% |
| Less than 100 employees | 99.0% |
| Less than 500 employees | 99.7% |
| More than 500 employees | 0.3%  |

The dynamics of marketability discounts for the 99% of small businesses with less than 100 employees is simply not reflected in the studies based upon public companies. The cases of McCord v. Commissioner, 120 T.C. 358-2003, Lappo v. Commissioner, T.C.M 2003-258 and Peracchio v. Commissioner, T.C.M 2003-280 all rejected the “cookie cutter” approach to discounts based upon data from public companies.

Discount data from public companies is available, and there are several studies available which document appropriate discount rates for these larger companies. However for small, closely held companies, this data is not available. Minority interests in such companies are extremely difficult to sell.

#### **CONTROL DISCOUNTS AS APPLIED TO FAMILY MEMBERS OWNING SHARES**

IRS Revenue Ruling 93-12 applies in this instance. Prior to the issuance of Revenue Ruling 93-12, the IRS held a position that when transfers of stock comprised a controlling interest within the family unit as a whole, even though individual gifts of stock might not grant a controlling interest, per se, that discounts in value for the lack of control were not allowed. IRS Revenue Ruling 93-12 reversed this position, and holds that in the case of gifts of stock the following policy is in effect:

....“ If a donor transfers shares in a corporation to each of the donor’s children, the factor of corporate control in the family is not considered in valuing each transferred interest for purposes of Section 2512 of the Code, for Estate and Gift Tax purposes, the Service will follow Bright, Propstra, Andrews and Lee in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently a minority discount will *not be disallowed* (emphasis added) solely because a transferred interest, when aggregated with interest held by family members, would be part of a controlling interest. “

This would be the case whether the donor held 100 percent or some lesser percentage of the stock immediately before the gift. In appraisal practice, the appropriate discounts for Lack of Control and Restricted Marketability are applied consecutively and cumulatively.

### **BUILT IN CAPITAL GAINS**

The case of Estate of Dunn v. Commissioner, 301F 3<sup>rd</sup> 339 (5<sup>th</sup> Cir. 2002) reversed a previously held notion that a built in capital gains tax which is attendant to a low-basis high asset value situation established that the value should be reduced dollar for dollar for the capital gains tax liability. Estate of Jelke v. Commissioner, T.C.M 3512-03 U.S. App (11<sup>th</sup> Cir. 2007) found an assumption must be made for immediate liquidation rather than spreading the gain over the expected life of the investment. This now places four Circuit Court of Appeals on the side of taking a dollar for dollar deduction for Built-In Capital Gains tax in a Corporation. See Estate of Eisenberg v. Commissioner, 74 T.C.M. (CCH) 1046 (2<sup>nd</sup> Cir. 1997), Estate of Welsh v. Commissioner, 208 F. 3d 213 (6<sup>th</sup> Cir. 2000), Estate of Jameson v. Commissioner, 267 F. 3d 366 (5<sup>th</sup> Cir. 2001), Estate of Dunn v. Commissioner, 301 F. 3d 339 (5<sup>th</sup> Cir. 2002), and Estate of Jelke v. Commissioner, T.C.M 3512-03 U.S. App (11<sup>th</sup> Cir. 2007). The question of the proper way to reflect this deduction was not determined. There are two possibilities, (1) show marketability discount in value, or (2) reflect a contingent liability in the amount of the allowance for Built in Gains tax on the balance sheet.

### **CONCLUSIONS**

The courts have indicated that a complete defensible analysis of the applicable issues must be made from which an appraiser bases his decision. Because transfers of minority interests in closely held companies are very rare, and there are no historical data sources available for these discounts, the appraiser must rely upon his experience and judgment in determining the appropriate discounts based upon a hypothetical analysis.

The IRS states that valuation is a question of fact and the trier of fact must weigh all relevant evidence to draw the appropriate inferences. This begs the question of how can an appraiser draw inferences if there is no published data? Conventional statistical

analysis will neither be appropriate nor possible in this situation. There is, however, an available methodology called “heuristics” or the “heuristic paradigm.”

The vast majority of people are not familiar with the term “heuristics,” though we all use heuristics, probably without being conscious of it. The word is derived from the Greek word “Eureka” meaning “I have found it.” In the past twenty years it has been refined into a modern problem solving and analysis methodology, usually associated with “systems science.” It has been developed to deal with decision making and judgment making involving complex systems where specific reliable data is not available, and the time and cost of obtaining such data necessary for a conventional statistical analysis is simply not feasible.

Basically heuristics is the art of drawing inferences when faced with limited, incomplete or fuzzy data. It is based upon the innate human ability to recognize patterns. We do this spontaneously. Even reading the words on this page is a heuristic endeavor. The reader is not interpreting literally the meaning of each word (which itself is a heuristic endeavor), but is recognizing the pattern of ideas which the words convey.

To employ the heuristic approach requires two things:

- A human mind, which is genetically disposed to recognize patterns; and it must be a mind with,
- Significant experience in the general subject matter from which to recognize patterns.

Employing these attributes will allow an appraiser to collect heuristic data points, non of which permit a specific and defensible inference, but all of which serve to frame an array which can be judged for their apparent relevance, weighting them and ranking them to provide insights into the *probable effect* of specific issues that, in the case of discounts, would foster a reduction of value. It takes expert experience to do this well. This is likely the reason for the minimum two-years experience in valuing the type of asset being

appraised as set forth in the Pension Protection Act of 2006 – which now governs appraisals of this type.

A complete discussion of heuristics is beyond the scope of this article. The purpose here is to introduce the concept so that the reader may understand that such a methodology is not only available, but scientifically defensible, and to look deeper into it. Googling the word “heuristics” will lead to a number of sites, including Wikipedia, which can shed some light on this,

But the important point to remember is that as a result of the recent court cases, the analysis of discounts must be as complete and defensible as the analysis of the basic (majority interest) of the security. Rules of thumb won't work.

## ABOUT THE AUTHORS

Gerald W. Barney, is the President and Chief Appraiser of American ValueMetrics Corp ([www.americanvaluemetrics.com](http://www.americanvaluemetrics.com)), a business and equipment appraisal firm. He holds an MS degree in Cybernetic Systems and professional designations of CMEA and CSBA in appraisal standards. He began his career as a financial professional in 1971 as a NYSE, ASE, and NASD licensed securities broker dealing in mid-sized mergers and acquisitions and commercial real estate syndications. Since 1983 he has been active principally in providing financial services to small business, including business development, business appraisals, consulting, and business brokerage and financing. He is currently a principal shareholder of Triaz International, a firm engaged in small business brokerage, machinery and equipment brokerage and is a 100% shareholder of American ValueMetrics Corp. operating nation-wide in the areas of business and machinery/equipment appraisals.

Melisa Silverman holds a JD and professional designations of CMEA and SBA in appraisal standards. She has worked for small to mid-sized businesses managing sales and marketing. She was instrumental in forming strategic technology and small business partnerships for a variety of companies. She is an appraiser and partner of American ValueMetrics Corp., a business and equipment appraisal company and a partner of Triaz International, a small business brokerage, machinery and equipment brokerage firm. She is a board member of the Society of Financial Service Professionals and a member of National Equipment Business Brokers Institute, Society of Business Analysts and Estate Planning Council of Ventura County.