

Maximizing Discounts

An Analysis of the Discounts for Lack of Control, Marketability and Voting Rights

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KNOWLEDGE

Learning Objectives

CPE Information
Recommended CPE: 1
Delivery Method: Group Internet Based
Field of Study: Specialized Knowledge
Program Level: Basic
Advanced Preparation: None
Prerequisite: None



Explain commonly recognized discounts in valuations for gift tax purposes



Define factors that affect discounts – both within and outside of a planner's control



Describe how to structure planning documents to maximize discounts



About the Presenter Jason Buhlinger

- Valuation practice co-leader at Armanino Advisory LLC
- Background in Business Valuation and Forensic Accounting
- Employment
 - Armanino Advisory LLC (formerly Brown Smith Wallace LLP) 2007-2016, 2017- Present
 - MilliporeSigma 2016
 - Patheon (now ThermoFischerScientific) 2017
- Education
 - Fontbonne University (BSBA in Finance)
 - University of Missouri – St. Louis (MBA emphasis Accounting)

Valuation Advisory Services

1. Internal Revenue Code 409A and Accounting Standards Codification (“ASC”) 718: Compensation – Stock Compensation
2. Gift and Estate Tax Purposes
 - Operating Entities and Family Limited Partnerships
3. Fair Value
 - ASC 805: Business Combinations
 - ASC 350: Intangibles - Goodwill and Other
4. Complex Security Valuation
 - Preferred Equity
 - Options
 - Warrants
 - Convertible Debt with Embedded Features
5. Litigation Support Purposes
6. M&A Consulting
 - Buy Side and Sell Side Clients
7. Complex and Custom Financial Modeling
8. Real Estate
 - Commercial and multifamily properties
 - REITs, portfolios, trophy assets, etc.

Today's Topics

1. Valuation Discount Fundamentals

2. Maximizing Discounts



Section 1

Valuation Discount Fundamentals

Valuation Discount Fundamentals

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 seller [emphasis added], acting at arms 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.



Valuation Discount Fundamentals

Purposes and Types of Businesses

- IRS – Tax Compliance
 - Estate and Gift Tax Filing
 - Form 706 (estate) and 709 (gift)
 - Charitable Donations
 - Succession Planning
- Shareholder Buy-outs and Buy-ins
- Asset Holding Companies
 - Real Estate Investments
 - Stock Portfolios
 - Operating Companies
 - Carried Interests of Investment Funds
- Tenancy-in-Common Ownership in Real Estate
- Operating Companies
 - Closely Held with only a few owners
 - Complex with Venture Capital or Private Equity Investment

Valuation Discount Fundamentals

3 Main Types of Discounts

Discount for
Lack of Control

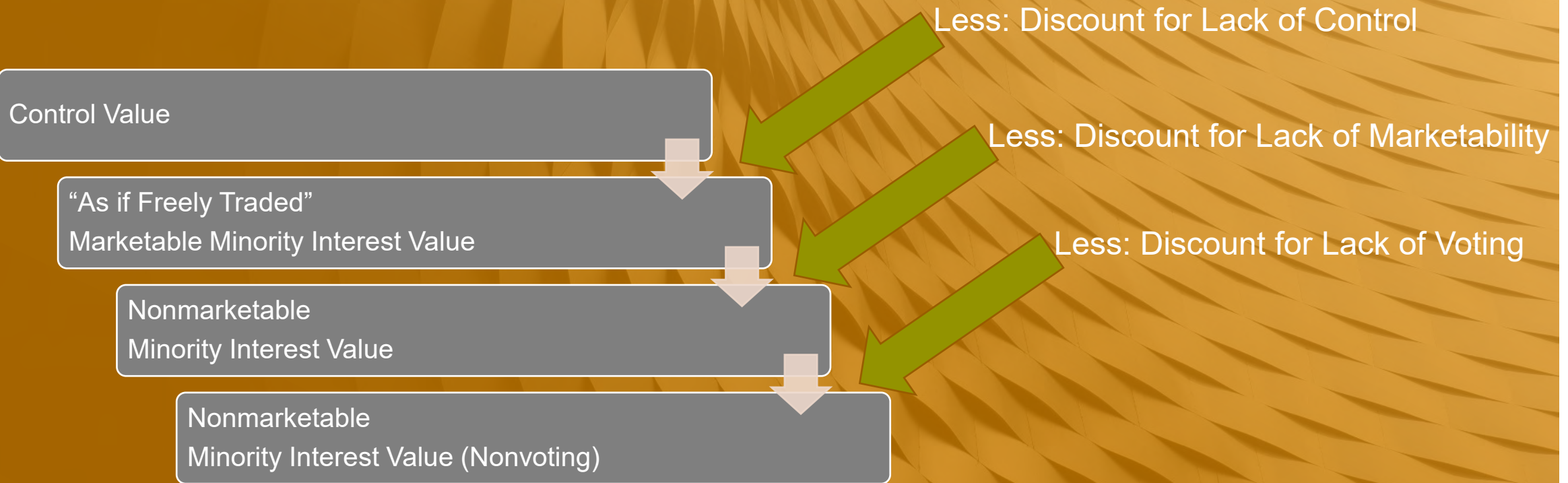
Discount for Lack
of Marketability

Discount for Lack of
Voting Rights



Valuation Discount Fundamentals

Levels of Value



Valuation Discount Fundamentals

Application of the DLOC and DLOM

The DLOC and DLOM should be applied sequentially.

Control Value	\$ 100.0
Less: DLOC (30% x \$100)	(30.0)
Minority as if freely-traded	70.0
Less: DLOM (20% x \$70)	(14.0)
Minority, non-marketable	\$ 56.0
<i>Effective combined discount</i>	<i>44.0%</i>

Valuation Discount Fundamentals

Discount for Lack of Control

- Owner of a fractional interest lacks control over the company's operations
- **Common prerogatives of control:**
 - Appoint management and board of directors
 - Determine management compensation
 - Set policy
 - Acquire, lease, or liquidate assets
 - Select suppliers, vendors, and subcontractors
 - Make acquisitions of other companies
 - Liquidate, dissolve, sell out, or recapitalize
 - Sell or acquire treasury shares
 - Register securities for an initial or secondary public offering
 - Declare and pay dividends
 - Change the articles of incorporation or bylaws

Valuation Discount Fundamentals

Market Research for Control Discount

- Publicly Registered Real Estate Partnerships
- Real Estate Investment Trusts (REITs)
- Closed End Funds
 - Smaller Discounts
- Publicly Announced M&A transactions
- Tenancy-in-Common Studies
- Analyze ratio of trading price to net asset value
 - Or trading price to M&A purchase price
- Compare characteristics
 - ❖ Type of real estate – (i.e. Multi-Family, Commercial Office, Retail, etc.)
 - ❖ Type of equity or stock (i.e. public vs. private company stock)
 - ❖ Distribution yield
 - ❖ Cash flow
 - ❖ Liquidation horizon
 - ❖ Diversification and size of portfolio

Valuation Discount Fundamentals

Discount for Lack of Marketability

- Ownership of a private corporation or fractional interest in private entity is not readily marketable
- Degree of Marketability depends on various factors
 - Dividend history
 - Size of block of shares being transferred
 - Company stage of development
 - Evidence of a market
- **Market Research**
 - Restricted Stock Studies
 - Private vs. Public Equity Returns
 - Tenancy-in-Common Studies
 - Put Option Methods

Valuation Discount Fundamentals

Discount for Lack of Voting Rights (DLOVR)

- Several studies and court cases have addressed premiums for voting rights.
- Studies/cases provide evidence as to the impact of voting rights for common stock
- DLOVR can be appropriate when valuing one share
- DLOVR generally at 0% or 5%

Houlihan Lokey Howard & Zukin Study⁽¹⁾

- This study measured premiums for voting stock versus non-voting stock in publicly traded companies by using the 60-day to 260-day moving averages. The 60-day moving mean and median premiums were 1.5% and 1.2%, respectively. The 260-day moving mean and median premiums were 3.2% and 2.7%, respectively.

O'Shea & Siwicki Study⁽²⁾

- This study measured premiums for voting stock versus non-voting stock in 43 publicly traded companies, which resulted in a 3.7% average premium and a 2.3% average premium after adjusting for outliers.

Barnes v. Commissioner (Tax), 1988

- Court accepted the average discount of 3.66% based on a study of 43 public companies with voting and non-voting stock.

Kosman v. Commissioner (Tax), 1988

- Court accepted IRS's expert based on Lease, McConnell & Mikkelson, but taxpayer's expert did not show any methodology for 10.0% discount applied. The court allowed and applied a 4.0% non-voting discount.

(1) Much, Paul J., Fagan, Timothy J. "The Value of Voting Rights." Financial Valuation, p. 1-7.

(2) Kevin C. O'Shea and Robert M. Siwicki, "Stock Price Premiums for Voting Rights Attributable to Minority Interests," Business Valuation Review, December 1991, p. 165-171.



Section 2

How To Maximize Discounts

How To Maximize Discounts

Overview

Planner Should:

1. Prove the limitations on control and marketability exist
2. There is a business purpose for putting those controls in place

Note: The valuation analyst only quantifies the appropriate discounts using the facts and circumstances at hand. The facts and circumstances can be tailored by the planner to ensure maximum discounts are achieved.

How To Maximize Discounts

What Drives Discounts



How To Maximize Discounts

Factors Within The Planner's Control

Discount for Lack of Control

1. Ownership Structure of the Entity

- 1% Voting and 99% non-voting
- Pro-rata
- General v. Limited Partners

2. Management of the Entity

- Manager managed v. Member Managed

Discount for Lack of Marketability

1. Right of First Refusal

2. Put/Call Options

3. Formula Driven Buy/Sell Agreements for:

- Ownership
- Specific Assets

4. Distribution Policy

How To Maximize Discounts

Factors Outside The Planner's Control

Discount for Lack of Control

1. Asset Mix
 - Cash
 - Marketable Securities
 - Receivables
 - Buildings
 - Land
 - Other Legal Entities (Tiered Discounts)
2. Control Premiums Paid in the Marketplace
3. Industry the Entity Operates In

Discount for Lack of Marketability

1. Time to Market the Interest
 - Large Minority Block v. One Share
 - WBE and Minority Owned Businesses
 - Overall Economic Environment
 - General contractors in 2009 v. 2020
2. Size/History of Distributions
3. Size of the Interest Being Gifted
 - Control v. Minority

How To Maximize Discounts

Ownership Structure Impact on DLOC

Assume 20% limited partner in partnership holding one income producing real property

Voting	Ownership	Impact	Discount Range <small>*general estimate</small>
Unanimous	75% / 20% / 5%	20% owner has veto power	15%-25%
Majority (Over 50%)	75% / 20% / 5%	70% owner has unilateral control	25%-35%
Majority (Over 50%)	20% / 10% / fourteen 5% owners	20% is largest, but no unilateral control	20%-30%

How To Maximize Discounts

Mandelbaum Factors

Mandelbaum v. Comm., TC Memo 1995-255 (1995)

- Seminal case involving factors to consider in a DLOM
- Opinion written by Judge Laro in 1995
- Court settled on a 30% DLOM based on a set of specific factors
- Factors are considered by many valuation professionals as a good conceptual basis for thinking about and quantifying the DLOM

Mandelbaum Factors

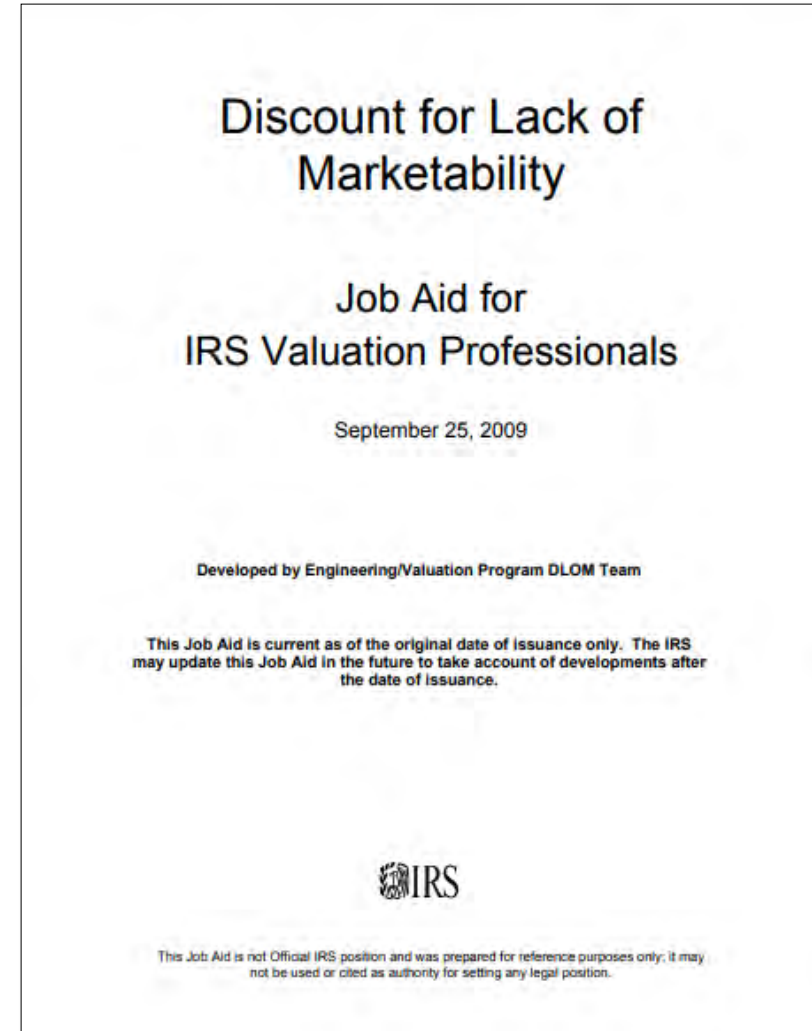
- Financial Statement Analysis
- Dividend Policy
- Nature of the Company
- Company's Management
- Amount of Control in the Transferred Interests
- Restrictions on the Transferability of the stock
- Holding Period for the Stock
- Redemption Policy
- Costs Associated with a Public Offering

How To Maximize Discounts

IRS Job Aid

Discount for Lack of Marketability (Job Aid for IRS Valuation Professionals)

- Published on September 25, 2009
- Developed by the IRS Engineering/Valuation Program Team
- Is not an official IRS position and was created for reference purposes only
- Still helpful to get insight into the IRS's thoughts around the various DLOM studies
- IRS recently removed this Job Aid from its website, but it still exists on the web.



How To Maximize Discounts

Discount for Illiquidity

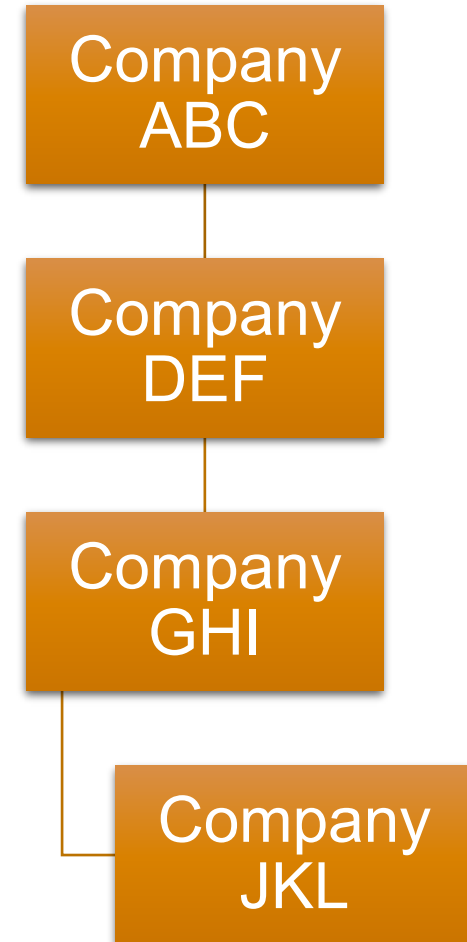
Discount for Illiquidity...Taken on Controlling Interests

- There are no empirical studies to support a discount on controlling interests
- However, there is time and cost associated with marketing a controlling interest
 - Cost shouldn't be factored in since securities are priced without factoring in brokerage costs
 - There is a time component though
- Some analysts believe no discount because owner reaps benefits when the company is marketed
 - What about factors outside the owner's control? Change in market conditions? Inability to pay dividends? What about earnouts or deferred payments upon a sale?
- Tax court has allowed DLOMs on controlling interests in the range of 3% to 33%, depending on the facts and circumstances

How To Maximize Discounts

Tiered Discounts and Recent Case Law

- Tiered discounts may be relevant when one legal entity owns an ownership interest in another legal entity
- Nelson affirmed the court's acceptance of tiered discounts
- Nelson v. Commissioner, TC Memo 2020-81, Affirmed 5th Circuit of Appeals Dec 21, 2021
 - Multi-tiered discounts were allowed with DLOC and DLOM
 - Court allowed a DLOC of 15% and a DLOM of 30% at the lowest level for operating company
 - At the Limited Partnership level, the IRS allowed a DLOC of 5% and a DLOM of 28%.
- Tiered discounts need to be analyzed on a case-by-case basis
- Need to avoid double discounting and consider the fair market value standard of value
- Some factors include, but are not limited to:
 - Size of interests valued
 - Voting v. non-voting rights
 - Written agreements
 - Different owners in each of the entities



Thank you for
attending

Additional Questions?

Reach out to us at

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