Viewpoint on Value

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Too good to be true?

Some courts are allowing multitiered valuation discounts

Tiered valuation discounts may seem too good to be true. But the Tax Court has upheld the concept in several high-profile cases, including *Astleford v. Commissioner* and *Gow v. Commissioner*. Here are some key considerations when supporting valuation discounts in a multitiered entity.

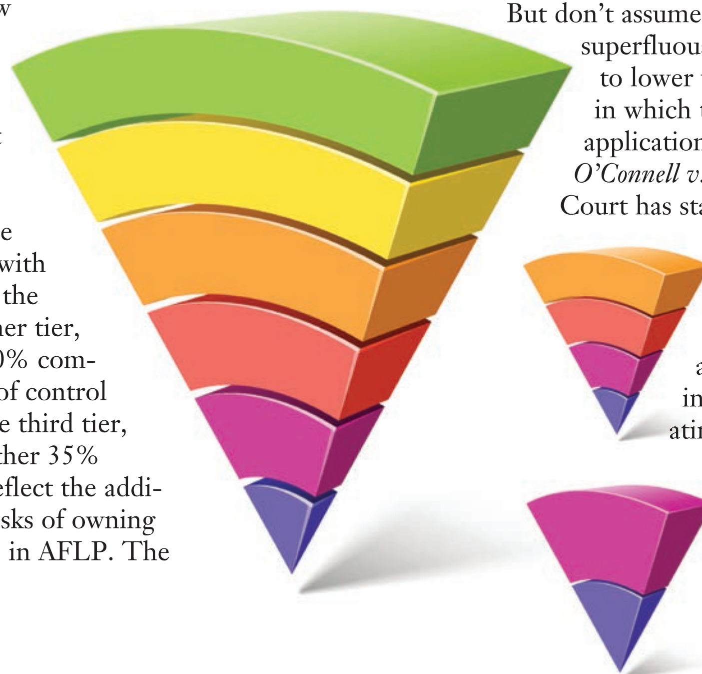
How do tiered discounts work?

Multitiered entities are businesses inside of businesses. Valuation theory permits separate discounts for lack of control and marketability at each ownership level to account for the incremental risk to which each new level exposes investors.

Decided in 2008, *Astleford* is the most recent high-profile case in which the Tax Court permitted tiered valuation discounts. Discounts taken on one of the partnership's many properties, Rosemont, helps to illustrate the process.

The IRS contested the value of limited partner units in Astleford Family Limited Partnership (AFLP), which owned a 50% general partner interest in Pine Bend. In turn, Pine Bend owned 3,000 acres of land, including 1,187 acres of farmland (Rosemont).

As the sidebar "How low can you go?" on page 3 indicates, the court allowed a 20% absorption discount at the first tier because it believed the Rosemont farmland property would flood the local real estate market with excess supply if sold. At the Pine Bend general partner tier, the court permitted a 30% combined discount for lack of control and marketability. At the third tier, the court agreed to another 35% combined discount to reflect the additional restrictions and risks of owning limited partner interests in AFLP. The effective combined discount added up to roughly 64% of the net asset value of Rosemont.



The range of discounts permitted in *Astleford* isn't an anomaly. In *Gow*, the Tax Court accepted discounts of 15% for lack of control and 30% for lack of marketability at the first tier, as well as additional discounts of 30% for lack of control and 30% for lack of marketability at the second tier for its 1990 stock valuations. So the effective combined discount was nearly 70%.

Valuation theory permits separate discounts for lack of control and marketability at each ownership level.

What potential pitfalls exist?

But don't assume that it's possible to add superfluous layers to an entity just to lower value. A well-known case in which the Tax Court denied the application of tiered discounts is *O'Connell v. Commissioner*. The Tax Court has stated that tiered discounts will be rejected if the lower-level interest represents a significant portion of the parent entity's assets or if the lower-level interest is the parent's operating subsidiary.

In *Astleford*, the court permitted tiered discounts, because Pine

Bend contributed less than 16% to AFLP's net asset value and was only one of 15 real investments. In *O'Connell*, a second layer of discounts was denied because the appraised entity (Capri, a real estate holding company) owned 95.3% of the first-tier entity (Glacier Assurance Company, an insurance firm).

Each additional ownership tier also should have a bona fide business purpose, such as asset protection, improved asset management or family business optimization. A layer of ownership may warrant a separate discount only if it poses additional risks and restrictions unique to that subject company. Inferior asset performance, corporate governance or distribution policies, or asset diversification may represent incremental risks.

With tiered discounts, the law of diminishing returns applies. The more layers there are, the less investors worry about each additional tier of restrictions and risks. At each level in a multitiered entity, an appraiser assesses the relative degree of control and marketability compared to subsequent levels.

Does the value make sense?

At the end of an appraisal assignment, valuators apply an objective reasonableness test to the final value. They look at the implied internal rate of return (IRR) and ask whether it makes sense compared to similar investments in the marketplace. For example, if an appraiser's final value implies an IRR similar to venture capital rates on a low-leverage, income-producing real property, the value might raise a red flag.

Not all tiered discounts survive Tax Court scrutiny. But reasonable, well-documented tiered discounts can dramatically lower value for gift and estate tax purposes. ●

How low can you go?

Astleford v. Commissioner (see main article) provides a real-life example of how tiered entities can warrant a significant effective combined discount off net asset value:

	Ownership interest	**Discount**
Tier 1	Rosemont farmland property	20% absorption discount
Tier 2	50% general partner interest in Pine Bend	30% discount for lack of control and marketability
Tier 3	Limited partner interest in AFLP	35% discount for lack of control and marketability
		63.6% effective combined discount*

* Note: The combined result of the tiered discounts is multiplicative, not additive. If the property had a net asset value of $100, its value inside AFLP was only $36.40 [$100 × (1 - 20%) × (1 - 30%) × (1 - 35%)].

Guideline public company method: Pros and cons

To determine the value of a private business, one thing valuators look at, of course, is other companies — both privately owned and public. Using the market approach, an appraiser seeks out similar companies to help estimate the subject company's value. A potentially useful variation of the market approach is the guideline public company method. However, it's important to understand this method's drawbacks.

How it works

Under the guideline public company method, an appraiser identifies companies whose stock (or partnership interests) is actively traded in the public markets, such as the AMEX or NYSE. Then he or she calculates key financial variables, using the stock price and a variety of pricing multiples such as price-to-revenue, price-to-net-income and price-to-book.

Financial variables may be calculated for several time periods:

- Next year's forecasted performance,
- The preceding 12 months, or
- An average of the past five years.

The appropriate pricing multiple depends on the specifics of the case and on the appraiser's professional judgment.

The subject company's fair market value equals the pricing multiple times the subject company's financial variable. That variable might be revenues; net income; earnings before interest, taxes, depreciation and amortization (EBITDA); earnings before interest and taxes (EBIT); or book value, among others.

The guideline public company method is based on quoted individual stock prices that represent a minority, marketable level of value. In that case, the appraiser may need to make an adjustment if he or she is valuing a controlling interest in the subject company. On the other hand, if a company is much smaller — and possibly more risky — than the guideline companies, an adjustment may be necessary to reflect the difference.

Some drawbacks

The availability of transaction data is a key determinant of whether an appraiser uses the guideline public company method. Pure players (companies that focus on a single target market or offer a limited menu of products) can be hard to come by in the public markets — especially in industries dominated by conglomerates.

In general, the guideline public company method makes more sense if the subject company is large enough to consider going public and when valuing a minority interest in a going-concern business. Using this method to value a controlling interest may require subjective adjustments for control.

Common mistakes

One common valuation mistake that may occur under the market approach is failing to adjust the financial statements of the subject company or the guideline companies to ensure accurate comparisons. For example, nonrecurring items and discontinued operations may need to be eliminated.

> The availability of transaction data is a key determinant of whether an appraiser uses the guideline public company method.

Or, for comparative purposes, the appraiser may need to rectify accounting inconsistencies — say, for depreciation or inventory methods. Ideally, an appraiser makes these adjustments before selecting guideline companies and computing pricing multiples.

Inconsistent terminology may also lead to problems. Slight differences in the ways databases or appraisers define terms such as "cash flow" or "earnings" can trigger significant valuation differences. It's imperative to understand how each database defines variables as well as what's included or excluded in the selling price.

Valuable insight

While public companies' common stock prices are easy to find, locating truly comparable public companies isn't so easy. This is because they are often conglomerates operating in several different industries. Many argue that public companies are larger and more sophisticated than midsize private companies and, thus, may not provide a relevant basis for comparison.

So the guideline public company method shouldn't be relied on without also considering other approaches. But when it's based on plentiful information, it can give middle-market buyers and sellers some insight into the factors driving a particular industry's market value. ●

Why levels of value matter

Defining the appropriate basis is key

A business may have more than one value, depending on the purpose of the appraisal and the characteristics of the ownership interest. Before jumping into an appraisal, you need to understand and agree with your appraiser on the appropriate level (or basis) of value. Otherwise, confusion over levels of value may lead to miscommunication — and to misinformed business decisions. Moreover, when multiple appraisers calculate different levels of value, discrepancies and disputes abound.

Taking control

Control value is one level. The ability to control a business's decisions has impact on value, especially on the value of a private firm. So, potential buyers often may be willing to pay more for a controlling interest

than for a minority interest. The key to arriving at a control value is to make discretionary adjustments to the company's cash flow, such as adjusting for above- (or below-) market-related party transactions or owners' compensation.

Control value can be broken down further into 1) strategic and financial control value or 2) public and private control value. But appraisers don't always agree on these classifications. The difference between strategic and financial control is the expected synergies available to a strategic buyer. Strategic buyers often pay a premium over financial buyers.

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Public and private merger-and-acquisition (M&A) methods generate cash-equivalent control values. Some valuators contend that controlling interests take time and resources to sell and, therefore, may warrant an illiquidity discount — regardless of whether they are based on public or private transactions. No empirical studies exist, however, that directly quantify illiquidity discounts.

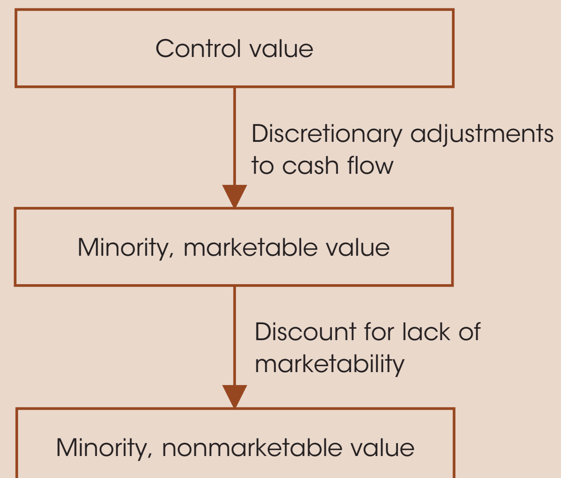
In the minority

Another level is minority, marketable value. Minority shareholders who can't control day-to-day business operations sometimes are unwilling to pay as much per share as controlling shareholders. Rather than take an indirect discount for lack of control, valuators typically arrive at a minority level of value by abstaining from making discretionary adjustments to cash flow.

Because public companies' professional management teams typically try to maximize earnings per share, their financial statements may require few or no discretionary adjustments. Assuming controlling shareholders don't abuse their discretion (as may be the case with a public company), the pro rata share of a public company's value on a controlling basis closely approximates the value of shares on a minority, marketable basis. In other words, there's little to no discount for lack of control in these cases.

Conversely, marketability refers to how quickly and easily shares can be converted to cash. Shares of Microsoft Corporation are sold on the New York Stock Exchange and can be bought or sold simply

Simplified levels of value



by calling an investment advisor, for example. Marketability is worth something to investors. Both the guideline public company method and the income approach can generate a marketable value, because they're based on public stock data.

No market

Finally, there's minority, nonmarketable value. Many appraisal assignments call for the value of a minority interest in a private company. This is generally the least valuable of the levels and is difficult to estimate directly, except by using previous arm's-length transactions of the subject company's stock. But previous transactions may not exist — or, if they do, they may not be relevant.

The typical starting point for this level of value is a minority, marketable value, as described previously. From there, a marketability discount is taken. Sources of empirical data for marketability discounts include restricted stock and initial public offering (IPO) studies.

Importance of forethought

Before valuing a business, work with your appraiser to establish some game rules. Because the appropriate level of value varies, it's important to discuss your options and make an informed decision under the guidance of an experienced valuation professional. ●

Help! When to call an appraiser

Often attorneys wonder when to contact an expert witness during the litigation process: when a lawsuit is filed, after discovery or once the trial date is set? Many hope to achieve an amicable out-of-court settlement without calling in outside expertise. But delaying an appraisal may come at a price.

Most valuators agree that it's never too early to contact them if there's a chance litigants will disagree about the value of a business interest. This doesn't mean paying the full appraisal fee up front, but it might require paying a refundable retainer. The initial phases of consulting with an expert can be fairly inexpensive and serve several important purposes.

First, consulting an expert tells the opposing side that you're taking the case seriously and prepared to battle, if necessary. Your perceived preparedness creates an incentive for the opposition to settle. In addition, by engaging an expert early you'll obtain essential information during the discovery phase, including an assessment of how much is at stake and whether it makes sense to pursue litigation.

Your appraiser also can provide a list of documents and procedures to request from the court. Access to the company's books and records, facilities, and management is essential to accurately valuing a business.

Perhaps the most egregious mistake is waiting until the last minute to contact an appraiser. Not only may the quality of a written report be compromised if you wait until just a week or two before trial, but the appraiser might calculate an unexpectedly high or low value, causing you to rethink your strategy at the last minute.

Valuation isn't an overnight process. An appraiser needs adequate time to define the assignment, gather facts and analyze the data. Judges frown on hasty valuation decisions.

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

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More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.***
The fax is ***203 - 380 - 1289****, and e-mail is* ***Mac@LeaskBV.Com****.*

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.