



Discount for Lack of Marketability Job Aid for IRS Valuation Professionals

Consultants' Training Institute

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Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals

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Overview of the Job Aid

- Dated September 25, 2009
- Released to the public July 2011
- Available at www.irs.gov/pub/irs-utl/dlom.pdf

What Is the Job Aid?

- A toolkit for IRS Valuation Analysts to use when considering Discounts for Lack of Marketability

Who Crafted the Job Aid?

➤ IRS Engineering/Valuation Program DLOM Team

- **Mike Gregory, ASA, AVA**
Engineering Territory Manager Issue Champion
- **Sue Kurzweil, CPA, ASA**
National Business Valuation Issue Coordinator Project Manager
- **Jeff Myers, ASA, AVA**
Engineering Team Manager Team Member
- **Laura Goldberg, AVA**
Engineer Team Member
- **Ernie DeRosa, AVA**
Financial Analyst Team Member
- **James McCann, ASA**
Financial Analyst Team Member
- **Aberdeen Sabo**
Estate Tax Attorney Advisor



Disclaimer

- Section E, *Evaluation and Recommendations*, should always be read in conjunction with Section D, *Summary of Approaches to DLOM*
- While certain of the studies reviewed may indicate larger discounts, such discounts are not appropriate in all facts in circumstances

Disclaimer

➤ Valuation Analyst must:

- Have clear understanding of the facts and circumstances of each interest to be valued
- Use professional judgment in choosing DLOM
- Apply a reasonableness test
- Get behind the data rather than using summary statistics

Structure of the Job Aid

➤ 7 Sections

- Executive Summary
- Introduction
- General Marketability Discount Information
- Summary of Approaches to DLOM
- Evaluation and Recommendations
- Summary and Conclusions
- Bibliography

Purpose of the Job Aid

- “...to provide a background and context for the Discount for Lack of Marketability as such is commonly applied in business valuation analyses and reports.”
- Not a “cookbook” approach to evaluating Discount for Lack of Marketability
- “...the establishment of a Discount for Lack of Marketability is a factually intensive endeavor that is heavily dependent upon the experience and capability of the valuator.”

Steps to the Project

- Defined DLOM
- Differentiated DLOM from DLOL and DLOC
- Reviewed long-standing methodologies
- Explored recent models in professional journals
- Discussed methods' pros and cons/strengths and weaknesses
- Looked for elements of reconciliation between models
- Developed pro forma IDRs and audit techniques

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GENERAL MARKETABILITY DISCOUNT INFORMATION

Introduction

- Purpose – to assist the IRS valuation analysts in their “examination of” and the “independent determination of” DLOM

Marketability vs. Liquidity

- Marketability: “...the ability to convert property to cash at minimal cost...with a high degree of certainty of realizing the anticipated amount of proceeds.”¹
 - “The fact of Salability”
- Liquidity: “The ability to quickly convert property to cash or pay a liability.”
 - “How fast the sale can occur at the current price”

¹ Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th Edition, McGraw-Hill, NY, 2007.

General DLOM Info

- A primary concern during this price reduction [DLOM] is that, over the uncertain time frame required to complete the sale, the final sale price becomes less certain, and with it, a decline in value is quite possible

General DLOM Info

➤ Propriety of DLOM

- DLOM is appropriate when the subject interest is non-marketable, yet the prior steps in the valuation process result in a marketable value
- DLOM is not appropriate if the prior valuation process has already taken marketability concerns into consideration

General DLOM Info

➤ Propriety of DLOM

- DLOM is applied after the minority interest discount or control premium where such is appropriate to a valuation problem
- DLOM should be determined on its own factors and not combined with other discounts

General DLOM Info

➤ Three Clarifying Examples

- If an asset is liquid, it is marketable
- If it is non-marketable, it is illiquid
- Being illiquid does not necessarily equate to being non-marketable – the asset may still be sellable, but not quickly or without loss of value

Factors Influencing Marketability

➤ Subject **Company** Factors (Modeled after *Mandelbaum*)

- Value of subject corporation's privately-traded securities vs. its publicly-traded securities (or if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock)
- Dividend-paying (or distribution) ability and history
- Dividend yield

Factors Influencing Marketability

➤ Subject **Company** Factors (Modeled after *Mandelbaum*)

- Attractiveness of subject business
- Attractiveness of subject industry
- Prospects for a sale or public offering of the company
- Number of identifiable buyers
- Attributes of controlling shareholder, if any

Factors Influencing Marketability

➤ Subject **Company** Factors (Modeled after *Mandelbaum*)

- Availability of access to information or reliability of that information
- Management
- Earnings levels
- Revenue levels

Factors Influencing Marketability

➤ Subject **Company** Factors

(Modeled after *Mandelbaum*)

- Book-to-market-value ratios
- Information requirements
- Ownership concentration effects
- Financial condition

Factors Influencing Marketability

➤ Subject **Company** Factors (Modeled after *Mandelbaum*)

- Percent of shares held by insiders
- Percent of shares held by institutions
- Percent of independent directors
- Listing on a major exchange
- Active vs. passive investors

Factors Influencing Marketability

➤ Subject **Company** Factors (Modeled after *Mandelbaum*)

- Registration costs
- Availability of hedging opportunities
- Market capitalization rank
- Business risk

Source: *Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals*,
September 25, 2009 (www.irs.gov/pub/irs-utl/dlom.pdf)

Factors Influencing Marketability

➤ Subject Interest Factors

- Restrictive transfer provisions
- Length of restriction period
- Length of expected holding period
- Offering size as percent of total shares outstanding

Factors Influencing Marketability

➤ Subject Interest Factors

- Registered vs. unregistered
- General economic condition
- Prevailing stock market conditions
- Volatility of stock

Source: *Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals*, September 25, 2009 (www.irs.gov/pub/irs-utl/dlom.pdf)

Mandelbaum v. Commissioner

- Decision authored by U.S. Tax Court Judge David Laro
- Seemingly combined elements of risk commonly considered within the constraint of building a discount rate, along with other parts of the valuation, with those required to be considered in developing DLOM
- Nothing in the Job Aid addresses how to avoid the double-counting of investment risk in different parts of the business valuation process

Mandelbaum v. Commissioner

- Judge Laro's finding was that little consideration was given to the hypothetical "willing seller" in the definition of fair market value under Revenue Ruling 59-60 in determining DLOM
- Although the willing seller must be considered, the focus on the willing seller should not be of detriment of the willing buyer as a way to attack the DLOM

Minority v. Controlling Interest

- “...it is generally agreed the DLOM of a controlling interest is less than that for a minority interest.”
- Job Aid does not elaborate on any measurable means to compare controlling-interest vs. minority-interest DLOM
- “General DLOM Information” section includes a “Sample Initial Information Document Request” listing 17 specific items to be requested before a reviewer begins an examination

Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals

SUMMARY OF APPROACHES TO DLOM

4 Categories of Approaches

- Benchmark study approaches
- Security-based approaches
- Analytical approaches
- Other approaches

Job Aid Provides

- Background/summary of each approach
- Areas of focus by the IRS
- Strengths and weaknesses of each approach
- Court opinions regarding each approach

Benchmark Study Approaches

Approach	Strengths	Weaknesses	Court Opinion
Restricted Stock Studies	<ul style="list-style-type: none"> • Stock is identical to freely traded counter-part, except for duration of resale restriction • One of few areas where concentrated research produced actual numerical values • Historically accepted by Tax Court 	<ul style="list-style-type: none"> • Rely on historical market data – may not reflect current market conditions • Change in holding period for restricted stocks • Reliance on averages of restricted stock studies 	<ul style="list-style-type: none"> • Court has rejected using average results in favor of detailed comparisons

Benchmark Study Approaches

Approach	Strengths	Weaknesses	Court Opinion
Pre-IPO Studies	<ul style="list-style-type: none"> • Empirical evidence, market data • Broad time coverage 	<ul style="list-style-type: none"> • Often too much time elapses between pre-IPO transaction and public offering • Pre-IPO companies evolve rapidly • Data includes only companies with successful IPOs • Tend to be underpriced • Usually involve related-party transactions • Frequently inflate DLOM 	<ul style="list-style-type: none"> • Rejected by court in <i>McCord</i> case • Dr. Mukesh Bajaj as leading government expert

Benchmark Study Approaches

Approach	Strengths	Weaknesses	Court Opinion
FMV Opinions Study	<ul style="list-style-type: none"> • Two-step approach • 475 transactions (now 597) 	<ul style="list-style-type: none"> • FMV has not shown that block size is a reliable proxy for quantifying DLOM • Steps in FMV analysis are interrelated and corrupted by each other • Discounts in FMV database are discounts on particular offerings 	<ul style="list-style-type: none"> • Court is in favor of using more detailed analysis of transactions instead of using average results • Many critiques of the study in Job Aid (not necessarily from courts)

Benchmark Study Approaches

Approach	Strengths	Weaknesses	Court Opinion
Restricted Stock Equivalent Analysis	<ul style="list-style-type: none">• Accounts for additional discount applicable to private companies having less marketability than restricted stock of public companies	<ul style="list-style-type: none">• New approach, has not had significant exposure in courts	<ul style="list-style-type: none">• Has not been vetted yet by court

Benchmark Study Approaches

Approach	Strengths	Weaknesses	Court Opinion
<i>Mandelbaum Factors</i>	<ul style="list-style-type: none"> • Raises importance of skilled application of benchmark studies • Similarity to precepts of Rev. Rul. 59-60 	<ul style="list-style-type: none"> • Difficult to obtain sufficient information to analyze and opine on all factors 	<ul style="list-style-type: none"> • Helpful guide to determining the DLOM

Security-Based Approaches (Option Pricing Models)

Approach	Strengths	Weaknesses	Court Opinion
Long-term Equity Anticipation Securities (LEAPS)	<ul style="list-style-type: none"> • Twice the number of transactions as the restricted stock studies • LEAPS can be found that are valuation-date specific • Data can be segmented by industry 	<ul style="list-style-type: none"> • Owner of privately held company can't hedge investment (LEAPS considered put option) • Appraiser would have to adjust LEAPS-based discount for private company considerations 	<ul style="list-style-type: none"> • Have not been vetted yet by court

Security-Based Approaches (Option Pricing Models)

Approach	Strengths	Weaknesses	Court Opinion
Longstaff Study	<ul style="list-style-type: none"> • Can be easily implemented in Excel • Provides benchmark maximum estimate on DLOM 	<ul style="list-style-type: none"> • Assumes investor has perfect market timing • Assumes investor has trading restrictions that prevent security from being sold at optimal time • Produces estimate of upper boundary for DLOM 	<ul style="list-style-type: none"> • Has not been vetted yet by court

Security-Based Approaches (Option Pricing Models)

Approach	Strengths	Weaknesses	Court Opinion
Chaffe Study	<ul style="list-style-type: none"> • Easily implemented into Excel • Based on European put option Black-Scholes Formula 	<ul style="list-style-type: none"> • Considered a minimum DLOM • Owner of privately held company stock does not have opportunity to hedge investment 	<ul style="list-style-type: none"> • Has not been vetted yet by court

Analytical Approaches

Approach	Strengths	Weaknesses	Court Opinion
Wruck Analysis	<ul style="list-style-type: none"> • Has a clearly defined hypothesis • Isolates DLOM from other factors • Analysis logically supports DLOM 	<ul style="list-style-type: none"> • Data selection based on data availability rather than logical selection methods • Measure point is day after announcement date-inflates discount amounts 	<ul style="list-style-type: none"> • Has not been vetted by the court

Analytical Approaches

Approach	Strengths	Weaknesses	Court Opinion
Hertzel & Smith Study	<ul style="list-style-type: none"> • More complete in analysis than Wruck • Determines seven variables affecting discounts • Primarily made up of smaller companies 	<ul style="list-style-type: none"> • Poor sample selection • Inability to determine registration status of many companies • Measurement date 10 days after announcement 	<ul style="list-style-type: none"> • Courts have not opined on this study

Analytical Approaches

Approach	Strengths	Weaknesses	Court Opinion
Bajaj, Denis, Ferris & Sarin Study	<ul style="list-style-type: none"> • Concentrates primarily on companies traded over-the-counter • Five discount parameters 	<ul style="list-style-type: none"> • Low coefficient of determination generated by regression model • Data errors in sample • Bajaj himself has been inconsistent in application of approach 	<ul style="list-style-type: none"> • No court has accepted Bajaj's 7.23% estimate as proper DLOM at face value • Court has used Bajaj's data to select DLOM based on summary results, arriving at 20%

Other Approaches

Approach	Strengths	Weaknesses	Court Opinion
Quantitative Marketability Discount Model (QMDM)	<ul style="list-style-type: none">• Quantitative basis• Uses specific factors to conclude a DLOM from matrix	<ul style="list-style-type: none">• Arbitrary/subjective estimation of factors• Matrix increases number of “opinions”	<ul style="list-style-type: none">• QMDM has been criticized in court but not rejected

Other Approaches

Approach	Strengths	Weaknesses	Court Opinion
Partnership Profiles	<ul style="list-style-type: none"> • Provide single combined discount (DLOC & DLOM) • Includes descriptive factors to help identify comparables 	<ul style="list-style-type: none"> • RELPs not representative or comparable to subject interests being valued • Inconsistent FMV standard • Shrinking pool of RELPs • NAV attributed to RELP re-sales might have been management estimates • Limited value to entities with substantial real property assets 	<ul style="list-style-type: none"> • Referenced in a variety of court cases • Sometimes questioned due to elements of both DLOC and DLOM inherent in study

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EVALUATION AND RECOMMENDATIONS



Evaluation & Recommendations

➤ Reviewer

- The Job Aid instructs the reviewer to consider the taxpayer's or appraiser's arguments for the approach or approaches chosen and for the numerical result decided upon.
- Preparation and submission of a full valuation report prepared in accordance with professional standards is the best position for a taxpayer to overcome an IRS challenge.

Evaluation & Recommendations

➤ Reviewer

- DLOM is a question of fact. Therefore, the burden of proof falls upon the taxpayer.
- Taxpayers have an opportunity to provide additional explanatory information to defend their discounts in the event of a challenge.

Evaluation & Recommendations

➤ Reviewer determining own DLOM

- Reviewer should ask “under the prevailing facts and circumstances and considering the nature of the interest to be valued, why is the DLOM not zero?”
- By enumerating the factors that would lead to a conclusion that a DLOM is appropriate, the reviewer will be building a framework to substantiate the DLOM’s reasonableness.

Evaluation & Recommendations

- **Dealing with marketability discounts in a report review under certain specific situations (5 addressed)**
 - Use of pre-IPO studies to support DLOM
 - Use of simple average or median from restricted stock studies
 - Use of analytical study results without getting behind the data
 - Use study results not supported by market data
 - Reliance solely on court decisions

Evaluation & Recommendations

- **Dealing with marketability discounts in a report review under certain specific situations (5 addressed)**
 - Valuers will avoid these five situations if adhering to valuation professional standards

Evaluation & Recommendations

➤ “Prepackaged” and “canned” responses to IRS DLOM positions:

- Valuation practitioners should make their own determinations and assessments
- Preconceived conclusions by the reviewer challenges the idea of open discussion for issue resolution

Evaluation & Recommendations

➤ Sources Available to Valuation Analysts

- FMV Restricted Stock Study database
www.fmv.com/index.php?C=Restricted_Stock_Study
- Valuation Advisors Pre-IPO databases
www.bvmarketdata.com

Evaluation & Recommendations

➤ Sources Available to Valuation Analysts

- Criticisms of FMV database by Job Aid
 - FMV's model is flawed, insofar as the explanation of the DLOMs on the restricted stock transactions in their database
 - Valuers cannot confidently rely on FMV's model when determining DLOMs on restricted stocks, much less on interests in private equity
 - Neither FMV's model nor multivariate regression analysis can be applied to FMV's database to confidently determine the DLOM on private equity