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Editor believes Tax Court erred in *McCord* case illiquidity discount

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In the case of *McCord v. Commissioner*,[1] I believe that the Tax Court erred in both its methodology and its final conclusion regarding the discount for lack of marketability.

Court uses restricted stock discount

The court concluded a discount equal to the average discount on a selected sample of 29 restricted stock transactions that took place from 1990 through 1995. The court concluded a 20% discount for lack of marketability (rounded from the 20.36% average discount in the selected sample).

Restricted stocks are, by definition, stocks of publicly traded companies that are prohibited from public trading for some limited time. When the restrictions expire, the holder enjoys an established public market into which the stock may be freely sold.

Private company interest less liquid

Surely, an interest in a private company that has no established market and is not likely to ever have an established market is less marketable than a restricted stock of a public company. Therefore, if the average discount for a group of restricted stocks is used as the starting point for a discount for lack of marketability for a closely held business interest, some upward adjustment should be made to the observed discount to reflect the lesser marketability of the closely held interest.

Secondly, if average discounts for restricted stocks are used unadjusted, the post-1990 data includes a downward bias to the observed discounts relative to closely held company interests. This is because the SEC relaxed the restrictions under Rule 144 in 1990, making restricted stocks more liquid. This resulted in lower discounts than were prevalent before 1990, thus making the restricted stock data one step further removed from closely held interests.

Pre-1990 average discounts are relevant

I agree with the conclusion of Kathryn Aschwald of Columbia Financial Advisors that "for purposes of determining discounts for lack of marketability of privately held securities, restricted stock studies relying on transaction data after 1990 are no longer relevant."[2] Data after 1990 can be useful in identifying *factors that differentiate levels of discounts for lack of marketability*, but for *average levels*, the pre-1990 data are the most relevant.

I frequently hear people opine that the transactions from 1966 through 1990 cannot be relevant for valuations in the late 1990s or 2000s. My own perception is that investors preference for liquidity (or dislike of illiquidity) did not suddenly change in 1990, when average discounts for restricted stock transactions went down from the mid 30s to the mid 20s. The lowering of the

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[1] 2003 U.S. Tax Ct. LEXIS 16, 120T.C.No. 13 (U.S. Tax Ct. May 14, 2003).
[2] Kathryn F. Aschwald, “Restricted Stock Discounts Decline as a Result of 1-Year Holding Period,” Business Valuation Update™ (May 2000): 1-5.

discounts was a response to the increased liquidity of restricted stocks, not a change in investor preferences.

Discounts notably consistent over time

The long series of restricted stock studies spanning the period from 1966 through 1990 resulted in remarkably consistent discounts averaging about 35% in most studies. Moreover, the average discounts in the other line of discount for lack of marketability studies the pre-IPO studies did not decline after 1990. The pre-IPO studies were also remarkably steady from their inception in 1975 to the present, indicating average discounts in the 45 to 50% range.

The pre-IPO studies move a step closer to measuring discounts for lack of marketability for closely held business interests than the restricted stock studies. They consist of transactions in privately held stocks prior to an initial public offering compared with the subsequent public offering price in the same stock.

Three lines of pre-IPO studies

There are three lines of pre-IPO studies:

- The Willamette Management Associates studies

    Eliminate insider transactions and options

    Cover transactions up to three years prior to the IPO

    Adjust for changes in company earnings and industry P/E ratios

- The Emory studies

    Include all transactions for the time period of each study

    Cover transactions up to five months prior to the IPO; in case of multiple transactions in the same stock, select the earliest

    No adjustments

- The Valuation Advisors Lack of Marketability Discount Study

    Includes *all* transactions, classified by common stock, convertible preferred stock, or options

    Covers all pre-IPO transactions from 1998 through the present (well over 2,000 total transactions)

    No adjustments in database but transactions identified so that the analyst can go to SEC filings and make any adjustments desired

Bajaj criticizes pre-IPO studies

The *McCord* opinion states

> "[I]n his rebuttal testimony, Dr. [Mukesh] Bajaj offers a compelling criticism of both the Willamette studies and [the Emory studies]. He concludes that the latest study conducted by Mr. Emory is biased because it does not adequately take into account the highest sale prices in pre-IPO transactions, and he criticizes the Willamette studies for not disclosing enough data to reveal whether they suffer from a similar bias. Dr. Bajaj has convinced us to reject as unreliable Mr. [Will] Fraziers opinion to the extent it is based on the IPO approach."

I would not characterize those arguments by Dr. Bajaj as "compelling" and certainly not "convincing." The design of the Emory study to select the transaction farthest away from the IPO certainly is a consistent selection criterion and arguably a better proxy for discounts for lack of marketability than those closer to the IPO date.

Bajajs criticisms "agnostic"

In response to his criticism of the Willamette studies for not disclosing enough data to reveal whether they suffer from a similar bias, he stated that his opinion is purely agnostic, that is, he admits that he doesnt know. I hardly think that this admission is either "compelling" or "convincing" evidence. In fact, when Willamette has used its database in court, the underlying data has always been provided to the opposing side for cross-examination.

Unfortunately, the concurring and dissenting opinions in this case dealt primarily with the (arguably more important) legal issues rather than with the valuation issues. Only Judge Chiechi addressed the valuation issues:

> I cannot responsibly cast an affirmative vote with respect to the portion of the majority opinion under the heading "V. Fair Market Value of the Gifted Interest". The determination of fair market value is a factual determination and is necessarily a matter of judgment and approximation. See, e.g., *Estate of Davis v. Commissioner, 110 T.C. 530, 537 (1998).* I am not in a position to state that I agree with every judgment and every approximation made by the majority opinion in determining the fair market value of the gifted interest. Moreover, because valuation is a factual matter and necessarily an approximation and a matter of judgment, I do not believe that the Court is bound in other cases by the judgments and approximations in the majority opinion.

We can only hope that this paragraph in Judge Chiechis dissent is heeded in future Tax Court cases dealing with the issue of discounts for lack of marketability.

Editors note: *The full 117-page opinion, including concurring and dissenting opinions, is available on* BVLibrary.com.

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