Latest Court Looks at DLOM: Assumptions Are Everything

***Temple v. United States,* 2006 U.S. Dist. LEXIS 16171 (March 10, 2006)**

No analytical model can "fix" flawed assumptions; and no study—no matter how valid the data—can overcome a flawed application. That seems to be the lesson the *Temple* court hammers home in its discussion and determination of discounts for lack of marketability and control. The discussion won't end with this case, however, as the decision leaves a couple of key questions on models and methods open for debate.

Valuations of $34 million gifts requires an army of appraisers

After developing a $2 billion timber company in Texas, Arthur Temple and his wife transferred over $34 million in assets to their children and grandchildren, using four family-owned entities: (1) Ladera Land, Ltd. ("Ladera"), which owned a ranch; (2) Boggy Slough West, LLC ("Boggy Slough"), which operated a winery; (3) Temple Interests, L.P. and (4) Temple Partners, L.P., identical partnerships that held publicly-traded securities (collectively, the "Temple Partnerships").

In valuing the gifts for his taxes, and without consulting an appraiser, Temple applied a 40% discount to Ladera and Boggy Slough. (The opinion doesn't mention initial discounts for Temple Partnerships). After its audit, the IRS declared that Temple had undervalued all gifts, and assessed an extra $3.54 million in taxes and interest.

Temple challenged the deficiency and hired a team of experts. Their first step—arriving at a net asset value for each entity, went as smoothly as a stroll on a Texas prairie. But the second—determining the appropriate discounts, put the experts in a Texas twister. To clear the dust from the data, the Court examined the analysis for each:

1. *Ladera.* Temple's expert, Nancy Czaplinski CPA, ASA, CFA (American Appraisal Associates, Inc.; Milwaukee), combined a 25% minority discount and a 45% discount for lack of marketability (DLOM) for a total 58.75% discount. For the minority discount, she used "the inverse of the premium for control" from a Mergerstat study. But a second Temple expert, Charles Elliot Jr., ASA, CFA (Houston), was forced to admit that the Mergerstat data involves sales from publicly-held companies and not the purchase of specific percentage interests; and that he'd never used the control premium study to compute a lack of control discount.

For the DLOM, Czaplinski used the Quantitative Marketability Discount Model (QMDM). Her inputs included a 10-15 year holding period and a 3% expected appreciation of property assets. As to the first, the Court found no holding period requirement in the controlling agreement; however, "under the [QMDM], the longer the holding period, the higher the discount." The Court also noted that Czaplinski had

derived the 3% expected appreciation from a "conversation with someone in her firm's real estate department" without an effort to tie the rate to Texas or other market comparables.

The holding period assumptions were "enough, in the absence of a holding period requirement . . . to concern the Court with the reliability of that aspect of Czaplinski's calculations." It also noted that she'd derived her remaining assumptions "without talking to anyone associated with Ladera."

On the other side, the government's expert, Francis Burns, ASA (InteCap, Inc.; Chicago), had examined average discounts for limited partnerships holding primarily real estate, which were similar to Ladera. "Burns's analysis allows for numerous data points and assists the Court in arriving at a reasonable discount," which it determined was a 33% combined discount for lack of control and marketability, plus an additional 7.5% incremental lack of marketability discount for a total discount of 38%.

2*. Boggy Slough.* Temple had transferred a 76.6% non-managing membership to one child, and several 1.6% interests to the grandchildren. To value these gifts, Czaplinski applied the same discounts (25% lack of control and 45% DLOM) as with Ladera. This time, the Court found more support for her calculations from fellow expert William Lyon, MAI, who took a sales comparison approach; he also considered the "numerous problems" associated with "absolute lack of control any individual [interest] has with respect to the property" and its dissolution. Given that any action required unanimous consent (and California entity law did not mandate dissolution), the Court concluded that a 60% discount was appropriate for the majority (76.6%) interest.

Surprisingly, the minority interests warranted a lower rate; the Court applied the same 38% combined lack of control/marketability discount to these as it had the Ladera gifts.

3. *Temple Partnerships.* For these identical investment holding companies, both parties' experts (Elliot and Burns) used closed-end funds to determine the minority discount and restricted stock studies to determine the DLOM. (The Court rejected a third Temple expert who calculated a DLOM that depended on a 50-year holding period.)

Once again the Court favored the more comprehensive Burns, who had not excluded any funds from his minority discount analysis, as Elliott had. Burns had also used the average discount of closed-end funds as opposed to Elliott, the Court said, who "simply chose the discount" from the 75th percentile without providing sufficient explanation or support. Applying the government's analysis to three valuation dates, the Court applied minority discounts in a range of 3.3% to 10.1%.

As for the DLOM, Burns had not only looked to the restricted stock studies but also to: academic research; costs of going public; secondary market transactions; asset liquidity; partnership interest transferability; and historic distributions. This "fuller" analysis persuaded the Court to adopt his 12.5% lack of marketability discount.

A gift to the taxpayer—more grist for analyst's discount mill

After applying the Court's discounts, the plaintiff did receive a $7 million refund of taxes and interest—proving that his army of experts paid off. But in its support for better substantiated detail and data; its questions on holding period requirements in the QMDM; and its application of a larger discount for a controlling interest, the *Temple* decision does keep the industry debate on discounts churning.