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by Lance Hall

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Discounts, Discounts, Discounts

By Lance S. Hall, ASA[*]

In the never ending conflict between the IRS and the Taxpayer, the disagreement over valuation discounts is often at the forefront. When we hear the word "discount," discounts for lack of control and lack of marketability immediately come to mind. However, as I have discovered during my career, there are a myriad of discounts that valuation experts often overlook including some that few of us will ever encounter. This article will take a cursory and, at times, amusing look at the many discounts that do not begin with lack of control and end with lack of marketability, with an emphasis on Court commentary. It should be noted that this article is not intended to be a comprehensive examination of any or all discount opportunities.

Key Person Risk

In the *Estate of Furman*[1], the Court was tasked with determining the fair market value of a decedent's 27 Burger King Restaurants. The still living son, Robert, ran the company and was considered to be key to the success of the company. As a result, the Taxpayer's valuation expert applied a 10% discount to reflect the key-person reliance on Robert. In considering the basis for a key person discount, the Court stated:

> Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform service for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee.

The *Furman* Court provided the key drivers of the 10% key person discount,

> Although a professional manager could have been hired to replace Robert, the following risks would still have been present: (i) Lack of management until a replacement was hired; (ii) the risk that a professional manager would require higher compensation than Robert had received; and (iii) the risk that a professional manager would not perform as well as Robert.

Personal Goodwill

Until the summer of 2014, in estate and gift tax cases, discounts that recognized the key contribution of an individual within a company were all referred to as key person discounts.

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[1] T.C. Memo. 1998-157 (April 30, 1998)

Invariably, if the key person discount was allowed, it was a one-size-fits-all 10%. However, as a result of the *Estate of Adell*[2] and *Bross Trucking*[3] cases, valuation professionals are now more attuned to taking personal goodwill discounts. In *Estate of Adell*, the *Adell* Court accepted the Taxpayer's Section 706 value (which represented a 90% discount from the notice of deficiency value) and, in *Bross Trucking*, the Court concluded that there was no gift. In other words, there was no value transferred, all because of personal goodwill.

The *Adell* and *Bross Trucking* Courts also concluded that if no employment agreement or non-compete agreement existed, the personal goodwill has not been transferred to the company and, therefore, it is not a part of the value of the company.

The Mafia Discount

This seldom encountered discount is, in fact, a justifiable discount. In the 1990s, the Department of Justice moved heavily against organized crime using the RICO statute as *Thor's hammer* to go after senior level Mafioso. In one instance, the Federal Government targeted a particularly senior member of a well-known New York Mafia family, alleging that this individual coerced another person into selling him a one-third interest in a nearby landfill at a below fair market value price. Given that the particular landfill had a well-documented history of over 20 years as being mob-owned, it was fairly easy to argue that any "hypothetical" willing buyer is going to understand that the other shareholders of the landfill are alleged Mafioso. Accordingly, from a fair market value perspective, the one-third interest value is lower than it would otherwise be if normal citizenry owned the other two-thirds.

Having been involved in this case, and for obvious reasons, I am unable to provide any more specific details. Suffice it to say, the Federal Government did not question my mafia discount.

Non-Homogeneous Property Discount

Real estate is a unique asset. Typically, when a portfolio of properties exists, the portfolio tends to be of a homogeneous nature, as is evidenced by the real property assets held by publicly traded companies. However, it is not uncommon for families to collect real estate in a haphazard manner resulting in dissimilar properties within their investment portfolio. In such instances, the hypothetical willing seller must find a buyer who is looking for that exact mix of properties. Property managers who specialize in a given property type, and with many years of experience, are more likely to perform better than managers who merely dabble in that specific property type. Investors recognize this and will not pay full value for a non-homogeneous property portfolio that they cannot control. In the *Estate of Bennett*[4], the Tax Court recognized this situation and stated, "We think some discounting is necessary to find a buyer willing to buy [the company's] package of desirable and less desirable properties."

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[2] T.C. Memo. 2014-155 (August 4, 2014)
[3] T.C. Memo. 2014-107 (June 5, 2014)
[4] T.C. Memo. 1993-34 (February 1, 1993)

The Built-in Gain Tax Discount

While the valuation industry is very familiar with this discount, few recall that the Tax Court did not allow a discount for built-in gain taxes, absent an immediate intent to liquidate, until 1998. In 1998, the Tax Court, in *Estate of Davis*[5], abandoned its prior position and stated:

> We are convinced … that even if no liquidation of [the corporation] or sale of its assets was planned … a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of [the corporation's] built-in gains tax.

The Corporate Form Discount

Tangentially related to the built-in gain tax discount, is the question of owning appreciating investment assets, such as real estate, in a C corporation where there is not yet any built-in gain. In other words, if the entity is liquidated today, there would be no capital gain on which to pay a tax. However, future appreciation would result in a built-in gain tax at a time uncertain. Would a discount still be warranted? In the *Estate of Bennett*[6], the Court stated:

> The benefits and burdens of corporate form are often the very reasons upon which the decision to apply or to not apply a discount for lack of marketability is based.

The Emotional Discount

Anyone working within the estate planning community knows that family dynamics may become emotional. Rarely, however, do we consider the impact that such emotions may have on value. In the *Estate of DiSanto*[7], the surviving brother bought out his deceased brother's interest at a substantial premium relative to the value that the estate used in its Section 706 filing. Naturally, the IRS objected, and the family went to court. The Tax Court sided with the estate in rejecting the buyout price saying, "The redemption was emotional for the DiSanto family. Emotional factors may preclude a redemption price from representing fair market value."

I have a slightly different take on the term "emotional" in this case. In fact, as a result of the company redeeming the deceased brother's shares, the company went bankrupt a few years after the brother's death. The children of the deceased brother were sitting pretty with their proceeds from the sale of the company stock and the children of the surviving brother were left without an inheritance – to me, *that* is emotional.

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[5] 110 T.C. No. 35 (June 30, 1998)
[6] T.C. Memo. 1993-34 (February 1, 1993)
[7] T.C. Memo. 1999-421 (December 27, 1999)

The Uncertainty Discount

The lesson from the *Estate of Newhouse*[8] is to write the governing documents in a confusing manner (e.g., relating to the rights and powers of classes of stock). This was a very large estate involving the Newhouse newspaper chain. The key issue was whether the subject interest could force a redemption of the preferred stock at a very low par value price. Depending on the answer, the difference in value was in the hundreds of millions of dollars. The Court rejected the IRS's higher value because the governing documents were confusing, stating:

> Where a state law issue about the relative rights and duties of different classes of stock is incapable of resolution except through actual litigation, as evidenced by the profound disagreement of several noted experts, a willing buyer would experience uncertainty about the rights of the common shareholder. The willing buyer and willing seller would take into account the likelihood of protracted and unpredictable litigation in negotiating a purchase price.

This reasoning was also adopted in the *Adams v. U.S.*[9] because the rights of an assignee interest in a dissolved Texas partnership were not clear. In *Adams*, the Fifth Circuit stated:

> [The] legal uncertainty – which raises the specter of costly litigation in addition to an adverse result – is itself a factor that must be taken into account when appraising the fair market value of an assignee's interest for estate tax purposes.

The Williamson Act Discount

Some states, like California, have laws that favor the preservation of agricultural land. In California, under the Williamson Act, certain types of property can be taxed at a lower rate if the owner agrees not to develop the property for ten years. This agreement is renewed annually, automatically, for another ten-year period. Once the owner cancels the agreement, her property is taxed at a higher rate for the next ten years on property she cannot develop until the expiration of the ten-year period. According to the *Estate of Luton,*[10] "The discount should reflect that restrictions are placed on the land as a result of the Williamson Act and that the assets of the corporation are not liquid."

The Lack-of-Full-Control Discount

Often, valuation professionals make the mistake of assuming that any interest over 50% is a controlling interest. However, there are varying degrees of control. The highest degree of control rests with a 100% ownership. The next highest degree of control is dependent upon state laws that allow for the "squeeze-out" of the minority shareholders. The existence of a minority

[8] 94 T.C. 193 (February 28, 1990)
[9] 88 AFTR2d Par. 2001-5361(August 24, 2001)
[10] T.C. Memo. 1994-539 (October 27, 1994)

interest shareholder requires the majority owner to have a fiduciary responsibility to the minority shareholder. Accordingly, squeezing out the minority shareholder through appraisal rights statutes eliminates that responsibility. In Delaware, where most public companies file, owning over 80% of the shares gives the controlling interest shareholder the ability to force out the minority shareholders by repurchasing their shares at "fair value."

When examining the differences in control premiums between acquisitions of 50.1% to 79.9% interests, and acquisitions of 80.0% to 100%, the data clearly shows that there is a material difference in the size of the control premium. In a recent study that we performed, the control premium for acquiring 50.1 to 79.9% of a publicly traded company was a median of 17.2%, and a mean of 21.8%. On the other hand, for acquisitions of 80.0% to 100% the control premiums had a median premium of 29.5%, and a mean premium of 38%. Stated differently, the value of the stock acquired for blocks of stock representing 50.1% to 79.9% was 11.7% less (mean), or 9.4% less (median).

The Prior Court Decisions Discount

Too many of those who dabble in valuations look to the prior Tax Court discount determinations to support their selected discount. While attorneys and the IRS commonly use this tactic, the valuation professional is advised against it. As the Court stated in the *Estate of LeFrak:*[11]

> … we must remind the parties that the amount of discount must be decided on the basis of the record in the instant case, and not on what a court found reasonable in another case involving different evidence.

The Rules-of-Thumb Discount

Another area of caution for the valuation professional is the use of rules of thumb. Often, such rules of thumb are not well supported. In the *Estate of Renier*, the Court was asked to accept a myriad of rules of thumb techniques used by the estate's valuation expert. The *Renier* Court rejected them stating, "We place no weight on [the expert's] opinion. His report contains no explanation of, or analytical support for, the various 'rules of thumb' employed in reaching several of its valuation estimates."

The Swing-Vote Premium

Often, the IRS's valuation engineers will claim that a particular block of stock is so large as to provide a swing vote that has considerable value above its mere pro rata right to the income and sales proceeds of the company. However, such arguments rarely succeed. One important consideration involving a swing-vote block is that the hypothetical willing buyer is not a part of the family and, therefore, cannot be expected to assume that she can split the family in order to

[11] T.C. Memo. 1993-526 (November 16, 1993)

recognize the block's swing-vote attributes. As stated in the *Estate of Davis*[12], "… as of the valuation date it was unlikely that a member of decedent's family would join with an outsider to compel [the company] to act or not to act in a specified matter."

In any swing vote situation it is important to understand that, "The willing buyer and willing seller standard renders irrelevant the actual buyer and actual seller; however, the other stockholders are not irrelevant under the standard."[13] [emphasis added]

The Influence Premium

Closely connected with the swing vote premium argument is that the block in question provides considerable influence. In *Estate of Wright*, the Court acknowledged that a particular block of stock exercised substantial influence in the Company but stated, "Before a control premium may be applied … something more than 'substantial influence' is required."[14]

This sentiment was echoed in *Estate of Hendrickson*[15] where the decedent held a 49.7% interest and both sides acknowledged that the decedent, through his block, exercised effective control. Nonetheless, the *Hendrickson* Court stated, "While we recognize that elements of control may enhance marketability, we do not think that the estate shares were rendered marketable by virtue of their effective control."

The Mandelbaum Discount

Since the 1995 *Mandelbaum v. Commissioner* case[16], in which Judge David Laro laid out a ten-step discount analysis, valuation professionals have been tempted to follow it with the assumption that the Tax Court would look more favorably on their selected discount. This is a mistaken assumption. As stated by in *Peracchio v. Commissioner,*[17]

> To the extent [the expert] believes that the benchmark range of discounts we utilized in *Mandelbaum v. Commissioner* is controlling in this or any other case, he is mistaken. Nothing in *Mandelbaum* suggests that we ascertained that range of discounts for any purpose other than the resolution of that case.

The Assignee Discount

Assignees in partnerships do not have all the rights of a limited partner, such as the right to vote or the right to access partnership financial information. The *Estate of Kerr* recognized this, but boiled it down to simply an issue of voting, saying, "The only relevant difference between the

[12] 110 T.C. No. 35 (June 30, 1998)

[13] *Estate of Magnin* – T.C. Memo. 2001-31 (February 12, 2001)
[14] T.C. Memo. 1997-53 (January 29, 1997)
[15] T.C. Memo. 278 (August 23, 1999)
[16] T.C. Memo 1995-255 (June 12, 1995)
[17] T.C. Memo. 2003-280 (September 25, 2003)

rights of limited partners and assignees relates to a limited partner's right to vote on major decisions—a right not extended to the assignees."[18]

However, the status of an assignee may affect other rights that have value. As such, more substantial discounts than non-voting discounts may be allowed. In a particularly difficult case, the Court stated:

> …the legal uncertainty that obscures the extent, if any, to which an assignee has the right to provoke liquidation or, alternatively, to force a straight pro rata redemption of his interest, suggests that any effort to exercise such putative rights would be met with strong resistance from the remaining partners. This legal uncertainty - which raises the specter of costly litigation in addition to an adverse result—is itself a factor that must be taken into account when appraising the fair market value of an assignee's interest for estate tax purposes.[19]

The Right-of-First-Refusal Discount

The mere fact that a right-of-first-refusal exists may discourage potential buyers from putting in the time, effort, and money to determine an appropriate offer. In *Mandelbaum v. Commissioner*[20] the Court stated, "… we believe that the [ROFR] create[s] a chilling effect on prospective investors, and, accordingly, that some consideration must be given to the agreements' effect on the issue of marketability."

The Tiered Discount

When the subject interest is a minority interest in an entity that, in turn, owns a minority interest, the question often arises as to whether it is appropriate to take discounts at the asset level and the interest level. In *Astleford,*[21] the Court agreed to tiered discounting despite the IRS's vigorous opposition stating:

> We note that this Court, as well as [the IRS], has applied two layers of lack of control and lack of marketability discounts where a taxpayer held a minority interest in an entity that in turn held a minority interest in another entity.

However, the *Astleford* Court went on to caution:

> However, we also have rejected multiple discounts to tiered entities where the lower level interest constituted a significant portion of the parent entity's assets, or where the lower level interest was the parent entity's 'principal operating subsidiary.'

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[18] 113 T.C. No. 30 (December 23, 1999)
[19] *Adams v. U.S.* – 88 AFTR2d Par. 2001-5361, N.D. Tex. (August 24, 2001)
[20] T.C. Memo. 1995-255 (June 12, 1995)
[21] T.C. Memo. 2008-128 (May 5, 2008)

Nonetheless, the discounts obtained through tiered discounting may be substantial. In *Estate of Gow,*[22] the Taxpayer's expert's combined discounts for lack of control and lack of marketability for the tiered structures which totaled 66.7% for one valuation date, and 70.8% for the other date. The Tax Court accepted the Taxpayer's expert's discounts.

Summary and Conclusion

As the evidence indicates, there are a myriad of discounts in the tool box of the valuation professional. This article is not intended to cover all discounts and recognizes that, among others, it does not cover the undivided interest discount, the high VIX discount, the blockage discount, the market absorption discount, the volume discount, or the environmental discount. However, as the experts in mechanics say, "use the right tool for the right situation." Likewise, in the estate and gift tax valuation profession we should be more consciously aware of the opportunities to correctly apply discounts that reflect fair market value.

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[22] T.C. Memo. 2000-93 (March 20, 2000)