JOHN A. BOGDANSKI

Dissecting the Discount for Lack of Marketability

Discounts for lack of marketability are a familiar feature in valuing closely held businesses for federal wealth transfer tax purposes. Sometimes referred to as lack-of-liquidity discounts, these adjustments typically reflect the differences between the closely held shares being valued and those of publicly traded companies. When publicly traded stock prices are influencing the valuation of shares in a privately owned firm, logic compels that these differences be taken into account. The discount is available for partnership (and presumably LLC) interests as well as for corporate stock.[1]

Generally, the lack-of-marketability discount reflects the absence of an established market for the closely held shares being valued. As the IRS has acknowledged, "a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock."[2] Thus, the value of a closely held company's stock should be discounted to reflect the time, expense, and uncertainties that would be involved in creating a hypothetical market for it.

JOHN A. BOGDANSKI is a professor of law at Lewis & Clark Law School in Portland, Oregon. He is a former columnist on closely held corporations for THE JOURNAL OF CORPORATE TAXATION. This column marks his debut as a columnist for ESTATE PLANNING.

Over the years, two sets of market realities have been subsumed into the lack-of-marketability discount. The first is that federal and state securities laws restrict the ability of most holders of unregistered securities to sell them to others. Absent registration (which is usually costly), such shares can be sold to only a narrow class of buyers. The second aspect of the discount is that, apart from the impact of the securities laws, the value of closely held shares usually suffers from the trading public's relative ignorance of, and indifference toward, the issuer.

The *Mandelbaum* decision

Sometimes (but not always) the discount takes into account other factors that might decrease share prices. In this respect, the recent Tax Court decision in *Mandelbaum*[3] gives estate planners an opportunity to revisit the lack-of-marketability discount. The decision is noteworthy both for the absolute isolation of the issue—the size of the discount was the only disputed substantive item before the court—and for the unorthodox way in which the court resolved it.

The facts of *Mandelbaum* are not complicated.[4] The three Mandelbaum brothers were the shareholders of a New Jersey-based corporation named Big M, which owned a chain of successful women's clothing stores. In the early days, the corporation had only one class of stock, and each brother owned one third of it. In 1974, however, one of the brothers redeemed about 9% of the shares to raise $400,000 cash to help settle his divorce.

Beginning in 1976, the brothers began making gifts of small blocks of the stock to their children. In 1982 and again in 1988, the shareholders signed agreements that fixed the identities of the corporate directors and officers, and gave the corporation and the other shareholders a right of first refusal over a selling shareholder's stock. The 1988 agreement also gave any dying shareholder's estate the right to sell the shares back to the corporation, but the other shareholders would set the price for such a sale.

Perhaps influenced by the changes in the corporate tax law enacted in 1986, the corporation made an S election effective in 1987. Shortly thereafter, it recapitalized. In the recapitalization, Big M's stock was exchanged for Class A voting common stock and Class B nonvoting common stock. All the exchanging shareholders received Class B stock, totalling 9,637 shares, and each brother's immediate family received two shares of the Class A voting stock. (In keeping with the requirements of Sub-

chapter S, the voting and nonvoting shares must have been identical except for voting rights.[5]) The six Class A shares remained in the same hands throughout the years at issue in the case, but the brothers, who continued to own most of the value of the company immediately after the recapitalization, continued their gift-giving programs with respect to the Class B shares.

The gift tax dispute focused in part on gifts of small blocks of shares given by the brothers to their children at year-end in the years 1987 through 1990. The most significant transactions at issue, though, were each brother's transfer of 1,000 shares of Class B stock—a 10.4% block—to a respective grantor retained interest trust (GRIT) in February 1990.[6] Under these trusts, which were likely influenced by the presence of former Section 2036(c), the children received vested remainder interests after ten-year income terms retained by their parents.

On their gift tax returns, the taxpayers claimed gifts based on the following values per share of the transferred stock:

Dec. 1987	$1,469
Dec. 1988	2,335
Dec. 1989	2,473
Feb. 1990	1,560
Dec. 1990	1,560

The IRS saw things differently; its notice of deficiency proposed values that ranged from $2,789 in 1987 to $8,020 in 1989, resulting in gift tax deficiencies for the three families that exceeded $2.2 million in the aggregate. In the Tax Court, the IRS altered its position somewhat but still asserted relatively high values—including a value of $5,127 per share in February 1990—for the Class B stock.

By the time of the trial, the taxpayers and the IRS had agreed that the "freely traded value" of each share of the stock that was the subject of the gifts was as follows:

Dec. 1987	$6,631
Dec. 1988	7,376
Dec. 1989	8,675
Feb. 1990	7,325
Dec. 1990	4,397

These stipulated values took into account any applicable minority discount. As a result, the only substantive issue for the court to decide was the proper amount of the discount for lack of marketability.

As is typical, each side presented the report and testimony of an expert witness. The taxpayers' expert[7] sought a 75% discount for 1987 through 1989, and a 70% discount for 1990. The IRS's expert[8] pegged the appropriate discount at 30% for all the years.

The taxpayers' expert based his opinion largely on the assumption that a hypothetical minority investor would have to wait ten to 20 years for an investment in Big M to become liquid. In support of this assumption, he pointed to the company's spotty history of paying dividends. He also cited the following as justifying a higher discount: (1) the family control of the corporation; (2) the fact that the family desired to retain control (as evidenced by the shareholders' agreements); and (3) the relative youth of the managing family members. The expert bolstered his conclusion by recounting interviews he had conducted with investment firms that might be prospective buyers of Big M shares. These interviews, he contended, revealed that an investor would command a 35% to 40% annual return on equity. Given the long wait that such investors would have to endure to obtain substantial cash returns, the taxpayers' expert reasoned, discounts of 70% to 75% were appropriate.

The IRS's expert, on the other hand, based his view on three empirical studies of sales of restricted stock. These showed that the average discount for such shares was 30% to 35%. The IRS took the position that, because Big M was large and its profits were stable, a discount near the lower end of this range was warranted.

Tax Court's analysis

The court was unpersuaded by either expert. The taxpayers' expert, it said, focused too closely on problems that an investor would foresee and ignored the views of a hypothetical willing seller. To suppose that a willing seller of Big M shares would accept a 70% discount was, in the court's opinion, "incredible."[9] Moreover,

1 See, e.g., Harwood, 82 TC 239, 267–268 (1984), *aff'd without pub'd opin.*, 786 F.2d 1174 (CA-9, 1986), *cert. den.* (limited partnership interests); Estate of McCormick, TCM 1995-371, at 2266–2267 (general partnership interests); Moore, TCM 1991-546, at 2654–2657 (general partnership interests).

2 Rev. Rul. 59-60, section 4.02(g), 1959-1 CB 237, 242.

3 TCM 1995-255.

4 *Id.* at 1602–1612.

5 See Section 1361(c)(4).

6 One brother gave the stock to his wife, who in turn made the transfer to the GRIT.

7 Roger J. Grabowski of Price Waterhouse.

8 Paul Mallarkey of BDO, Seidman.

9 TCM 1995-255, at 1617.

the court chided the taxpayers' expert for relying heavily on the shareholders' agreements as a depressant factor on value. Because these agreements essentially established merely a right of first refusal, the court ruled that their influence on value was "not necessarily substantial."[10] As for the interviews with the investment firms, the court dismissed them as an invalid sample of potential buyers and added that the expert had not given the interviewees adequate information about Big M.

The IRS's expert fared no better. First, the court faulted him for underestimating the family's desire to retain control of the corporation. Ironically, it also criticized him for underestimating the "chilling effect" that the shareholders' agreements would have had on investors, even though the agreements established only a right of first refusal.[11] As for the three empirical studies that the IRS's expert consulted, the court found that they were not entirely helpful. The stock in the studies was subject only to short-term securities law restrictions, whereas the Big M stock might have to be held for years before an investor could expect substantial cash returns.

Factors considered

For all these reasons, the court announced that it would go it alone, fashioning its own technique for determining the discount's proper amount. Looking to various studies that the taxpayers' expert had cited, the court decided that 35% and 45% were "benchmarks" for the discount.[12] It then examined a series of factors that it said should determine whether a figure near the higher or lower end of that range should be selected. These factors were as follows:

1. *Financial statements.* Given Big M's strong capitalization, net worth, revenue, earnings, and cash flow, the court found that a below-average discount was appropriate.
2. *Dividend policy.* The court noted that the company had paid little in dividends, but it dismissed this factor based on Big M's strong income and cash flow. Given the company's historical growth and growth potential, again a below-average discount was indicated.

[10] *Id.*
[11] *Id.* at 1616.
[12] *Id.* at 1618.

3. *Company's history and position, and economic outlook.* Based on the company's diversification and profitability, even though it was not an industry leader, the court concluded that a below-average discount was proper.
4. *Management.* According to the court, Big M's "proven and experienced management team that is well known in the industry" favored a discount that was below average.
5. *Control inherent in transferred shares.* Noting that the blocks of stock that were the subjects of the gifts did not represent control of the company, the court determined that an average discount was indicated.
6. *Transfer restrictions.* The restrictions in the shareholders' agreements, stated the court, weighed in favor of an "above-average to average" discount.
7. *Holding period.* The court was unpersuaded by the taxpayers' expert's assertion that an investor would be required to wait ten to 20 years for a cash return. It also disagreed, however, with the IRS's expert's reliance on price studies of stock that was subject to only two-year restrictions. Thus, this factor was considered to be neutral.
8. *Redemption policy.* The fact that the corporation redeemed one brother's shares in his divorce indicated that a below-average discount was warranted.
9. *Public offering costs.* Because a buyer would not be able to minimize the registration costs that he might incur in trying to sell his shares, the court found that an above-average discount was proper.

Putting all these factors together, the court concluded that a below-average discount was appropriate. Hence, it sustained the IRS's contention that the correct lack-of-marketability discount was 30%. The result was a substantial defeat for the taxpayers.[13]

Penalties added another $440,000 to the total deficiency asserted in the IRS's original notice. The Tax Court negated all the penalties, however, due to the taxpayers' reliance on professional advisors.[14]

Critique of decision

The *Mandelbaum* court's analysis is remarkable in several respects. First, its consideration of the nine factors, with its scorecard of deviations from an average discount, is clearly atypical. Most often, courts simply comment on the work and arguments of the expert witnesses, and then select a percentage for the discount.

A closer examination of the Tax Court's approach, however, suggests that the court took into account factors not usually associated with the lack-of-marketability discount. Typically, these factors are accounted for outside the application of this particular value adjustment. Indeed, one might think that some of these considerations were already reflected in the "freely traded" values to which the parties stipulated, and that the court's incorporating them into the discount represents an unwarranted duplication.

For example, the company's financial statements have an obvious impact on the determination of the inherent worth of its stock, even with marketability concerns left aside. If one uses discounted cash flow to determine stock values, the company's revenue and earnings will clearly drive the basic valuation. Similarly, the business's track record and industry position will doubtlessly affect the capitalization rate used in the discounting process. Why should these features be counted once again in determining a lack-of-marketability discount?

To take another example, the absence of control in the transferred shares is normally taken into account by means of a minority discount. In *Mandelbaum,* the stipulated "freely traded" values expressly reflected any appropriate minority discount. Consequently, why should lack of control be counted again in calculating the lack-of-marketability discount?[15] And contractual transfer restrictions (such as buy-sell agreements) are typically considered outside of the discount; under Section 2703, in gift tax cases arising today, such restrictions must often be disregarded completely. Therefore, rolling them into the discount seems imprudent.[16]

The cleanest applications of the lack-of-marketability discount have been those designed to reflect the differences between closely held and publicly traded shares, when data from public trading prices (such as stock market price-earnings ratios) is being used to

[13] *Id.* at 1620–1621.

[14] *Id.* at 1621–1622.

[15] The same taxpayers' expert advocated the same blurring of this line, with similarly disappointing results, in Northern Trust Co., 87 TC 349, 385–386 (1986), *aff'd sub nom.* Citizens Bank & Trust Co., 839 F.2d 1249, 61 AFTR2d 88-1335, 88-1 USTC ¶13,755 (CA-7, 1988). Compare Moore, *supra* note 1 (restrictions on liquidation of partnership were already reflected elsewhere in valuation and should not affect illiquidity discount), with Estate of Gallo, TCM 1985-363, at 1605 (citing family control as supporting relatively large discount).

[16] See also Estate of Lauder, TCM 1992-736, at 3735 (court setting lack-of-marketability discount in determining effect of buy-sell agreement, rather than vice versa).

value a privately held firm's shares. The discount's key underpinnings are the absence of securities law registration for the private firm's shares, and the general trading public's lack of information about, and interest in, such a firm.

Certainly, the studies that are usually cited in support of the lack-of-marketability discount do not measure all the influences on value that the *Mandelbaum* court discussed. Most of these, like the SEC's Institutional Investor Study of the late 1960s, focus strictly on the effects of lack of registration and other securities law restrictions. For example, some compare prices paid by institutional investors for unregistered shares with prices of otherwise identical registered shares. Other studies compare prices paid by principals and insiders immediately before an initial public offering with public offering prices.[17] The studies generally do not address such factors as family control and private buy-sell arrangements.

Nonetheless, the *Mandelbaum* court is not the first to introduce seemingly extraneous factors into discussion of the lack-of-marketability discount. For instance, cases can be found using the phrase "lack of marketability" to describe the principal of blockage,[18] or discounts for minority or nonvoting status.[19] Perhaps the court was especially justified in considering numerous circumstances in *Mandelbaum* because of the vague stipulation of the base values from which discounts were to be taken. These were said to be the values of "freely traded" shares, reduced by any applicable minority discount. At least as described in the court's opinion, this stipulation did not specify precisely what market conditions the parties assumed in setting such values nor exactly which factors were to be included in the lack-of-marketability analysis.

Taken too far, however, the court's free-ranging approach threatens to have the discount swallow up the entire valuation process. Since the object of a federal tax valuation case is to determine fair *market* value, *any* factor that depresses such value could be dubbed a "lack-of-marketability discount"—an expansion of that term that would likely cause confusion.

In any event, the final chapter of the *Mandelbaum* story has not yet been written; the taxpayer has appealed to the Third Circuit.[20] Given the inherently factual nature of valuation questions, though, one would expect the appeals court to reverse only if the Tax Court's decision was clearly erroneous. And it is hard to conclude that the lower court's decision was that far off the mark.[21]

A 30% lack-of-marketability discount, *in addition to* any applicable minority discount (which was already reflected in the stipulated base values), certainly does not seem substantially lower than what most other recent court cases in this area have allowed.[22] When quantifying a *combined* discount for lack of control *and* lack of marketability, judicial decisions have tended to hover around 35%.[23] Therefore, the taxpayers' claim of a 70% to 75% discount for lack of marketability alone seems outlandish. A summary affirmance would not be at all surprising. ■

---

17 For a collection of the studies, see Pratt, Reilly, and Schweihs, *Valuing a Business* 335–348 (3d ed., 1995).

18 See, e.g., Estate of Oman, TCM 1987-71, at 375 ("lack of marketability of the large block of stock").

19 See, e.g., Capital City Excavating Co., TCM 1984-193, at 692 (value-depressing effect of nonvoting stock was "a discount to value to reflect lack of marketability"); Estate of Grootemaat, TCM 1979-49, at 207 (describing "discount for restricted market" exclusively in terms of control).

20 Docket No. 95-7567 (filed 10/20/95).

21 But see Long (letter to the editor), "Tax Court Again Ignores Financial Reality," 68 Tax Notes 121 (7/3/95) (criticizing decision as "astonishing," "appalling," and "in violation of elemental principles of due process").

22 See, e.g., Estate of McCormick, *supra* note 1 (20%-22% lack-of-marketability discounts, beyond 18%-32% minority discounts); Estate of Frank, TCM 1995-132, at 868–869 (30% lack-of-marketability discount, beyond stipulated 20% minority discount); Saltzman, TCM 1994-641, at 3516 (25% for lack of marketability); Estate of Simpson, TCM 1994-207, at 1119–1120 (30% for lack of marketability); Estate of Berg, TCM 1991-279, at 1392, *aff'd* 976 F.2d 1163, 70 AFTR2d 92-6259, 92-2 USTC ¶60,117 (CA-8, 1992) (10% discount for lack of marketability, 20% minority discount); Estate of Murphy, TCM 1990-472, at 2256 (20% discount for lack of marketability and inability to liquidate corporation).

But *cf.* Estate of Jung, 101 TC 412, 434–446 (1993) (35% lack-of-marketability discount, no minority discount); Estate of Lauder, *supra* note 16 (40% for "lack of liquidity"); Estate of Gallo, *supra* note 15 (36% discount for "illiquidity").

23 See, e.g., Estate of Newhouse, 94 TC 193, 249–252 (1990), *nonacq.* (35%); Ward, 87 TC 78, 109 (1986) (33.3%); Moore, *supra* note 1 (35%); Estate of Watts, TCM 1985-595, at 2667, *aff'd* 823 F.2d 483, 60 AFTR2d 87-6117, 87-2 USTC ¶13,726 (CA-11, 1987) (35%). But see Martin, TCM 1985-424, at 1889–1891 (70%).