Business Valuation and Discounts: An Art, Not a Science

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Overview

One of the more difficult aspects of business planning is the determination of the value of a business. Few business owners can immediately and accurately assess the true value of their business. In many instances, the business owner's accountant may become involved and assist in determining its value. A taxpayer, however, should approach the valuation process with an eye towards satisfying a potential challenge by the IRS. To accomplish this, it is best to utilize a qualified and experienced professional appraiser who examines all pertinent facts and circumstances of the business, including the industry in general and the state of the economy.[1]

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In valuing a business interest, the business owner must arrive at a price that is not only acceptable to him or her, but what he or she feels is fair to his or her family. Further consideration must be given to the IRS's interest in valuing the business interest for the purpose of assessing taxes. The business owner's desire to pay the least amount of taxes should not override his or her desire to have the fair value of his or her business interest pass to his or her family. Therefore, the valuation of the business interest should be designed to provide a fair value to both protect his or her family and satisfy a potential IRS inquiry.

It is fair to say there are numerous ways to value a business, with each method taking into account a multitude of facts and circumstances. It is these factors and their interrelationships that make the valuation process an art rather than a science. Some common valuation techniques are book value, adjusted book value (liquidation value) and fair market value, all of which are more specifically discussed below. Other internal and external factors may also affect the value of the business interest. These may include minority discounts, lack of marketability discounts, key person discounts, built-in capital gain discounts and blockage discounts, all discussed later in this article.

Fair Market Value

In general terms, fair market value is the price one would pay for a desired asset. However, we have a more stringent definition in IRC Regulation § 20.2031-1(b), which defines fair market value as follows:

> The fair market value is the price at which the property will change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having a reasonable knowledge of relevant facts.

Although this regulation provides us with a neat and clear definition of fair market value, applying the definition to the actual valuation of a closely held business interest is easier said than done. Recall that absent a buy-sell agreement which provides a willing buyer, a closely held business interest is generally not a readily marketable item.

[1] *See generally Bader v. United States*, 172 F. Supp. 833 (S.D. Ill. 1959).

The starting point in determining the fair market value of a closely held business may begin with a dialogue between or among its owners, usually an arm's-length negotiation. Typical questions that begin the process of determining the value of a business are:

> "How much will you pay to buy my share of the business?"
>
> "I'll offer you $X for your share of the business."
>
> "If we sell the entire business, what will a third party pay?"

Should the owners agree to a value, it may be used in a buy-sell agreement. However, special care will be required if the owners are related, since Chapter 14 of the Internal Revenue Code may be applicable.

Sometimes the owners will be in no position to determine a value among themselves and will depend on their accountant or an independent appraiser to determine the fair market value of the business. Although an accountant may be able to provide a valuation, a professional appraiser with proper qualifications is best whether or not a potential conflict with the IRS as to the value is anticipated. A professional appraiser can arrive at a valuation any number of ways using accepted valuation techniques. Until the valuation is ultimately accepted by the IRS, the possibility of IRS challenge to the valuation method always looms.

Some examples of methods used by professional appraisers are the capitalization of pretax earnings, the capitalization of after tax earnings, a multiple of gross revenues, a multiple of net income, the cost approach, the replacement cost approach or, in some specialized businesses, the application of a formula (*e.g.*, a funeral home may simply multiply the number of funerals by $X to arrive at the value of the business).

In using any of these methods, consideration will be given to the goodwill of the business, which is usually a value attributable to the business's reputation in the community and not attributable to the return on the business's assets. The well accepted starting point in determining the value of a closely held business is Revenue Ruling 59-60, which is discussed later in this article.

Book Value

The book value of a business is determined by review of its balance sheet, the document that shows the business's net worth: its assets less its liabilities. This value may be artificially low since normal accounting methods require the assets of the business to be valued at historical cost reduced by depreciation. It is rare that the book value of a business accurately reflects its true fair market value.

If owners who are not related agree on book value following an arm's-length negotiation, the IRS may accept the valuation for estate tax purposes. However, problems may arise if the owners of the business are parent-child or other family members since the IRS could attack the valuation as not being *bona fide* nor at arm's length. The IRS could characterize the book value valuation as an attempt to pass the business to the child or family member as a disguised bequest, applying the Chapter 14 valuation rules[2] and valuing the business at fair market value which, more than likely, will not be represented by book value.

Some business owners do value their business interests at book value in an attempt to minimize estate taxes. But is this good practice? Not necessarily. Although the

[2] *See generally* IRC § 2703.

objective to minimize estate taxes may be achieved, what really has occurred? Let's look at an example:

ABC Corporation has two equal shareholders, A and B. The corporation has a book value of $100,000, but a liquidation value of $500,000. If the buy-sell agreement provides for the purchase at A's death of A's 50% share at book value, B will pay $50,000 for an interest actually worth $250,000. B then owns the company outright, and if B sells it B will receive the entire $500,000. A or A's family has received $50,000 for an interest really worth $250,000. Is this fair to A's family? The family has suffered by receiving a fraction of the business's value. Usually, it is not in the best interests of the client and the client's family to artificially lower the value of the business by using book value in the buy-sell agreement.

Adjusted Book Value

Adjusted book value begins with book value and various adjustments are made to accurately reflect the current value of the assets. This is accomplished by subtracting the historical cost of the assets from the balance sheet and adding back the fair market value of the assets. These adjustments result in the liquidation value of the business, that is to say the "real" value of the assets less the business's liabilities. Generally, the adjusted book value is more indicative of the value of a business than the book value, but this still may not be the most accurate method of determining the true value of a business. For instance, it does not reflect goodwill in the business, which may be of particular value in an on-going business. It would also not be an accurate reflection of a personal service business, which typically does not have significant assets producing revenue.

Revenue Ruling 59-60

Revenue Ruling 59-60,[3] issued by the IRS in 1959, outlines eight factors to be considered in valuing a closely held business. While an old ruling, it remains the basic guide in this area. The factors are:

1. Nature of the Business and Its History

This factor addresses the type of business being valued, noting if it is a manufacturing concern, a personal service business, a wholesale business, a retail business or a combination of the foregoing. The business being examined will be reviewed from its creation date (or purchase date) to the date of valuation with an emphasis on the business's viability, the risks involved (past, current and future), the makeup of its operations (is it a one product company, a conglomerate or something in between), the management of the company (is it dependent on a key person or does it have depth in its management), and its financial history. This serves as background in helping the appraiser become familiar with the business and its inner workings.

This history should also highlight unusual events and items that have occurred during the business's life which may have an effect on the valuation of the business. For example, a condemnation by the government of the business's real property or the business's sale of a segment of its business will produce a large change in its financial statements in that year. A sale such as this will require the "removal" of extraordinary gain or loss in the year of the sale and will also require an adjustment to the business's future financial statements. If the segment sold was profitable, the loss of future profits from this business must be subtracted from the business's projected revenues. Conversely, if

[3] Rev. Rul. 59-60, 1959-1 C.B. 237.

the segment sold generated a loss, the removal of this drain on business revenue will result in greater profits.

2. The Economic Outlook in General and for the Specific Industry in Particular

The general economy will affect all businesses in one way or another. The business's industry outlook as it relates to the general economy, however, may be more important. For example, the real estate boom in the late 1970's and late 1990's provided a very favorable economy for builders and contractors as well as their suppliers. This situation turned around in the late 1980's and early 1990's when the real estate market became depressed. Therefore, the valuation of a business must include a review of the economy, which will be a factor in arriving at a fair market value. A good economy, however, will not always result in an increased value of a business nor will a weak economy always result in a lower valuation of a business. For example, bankruptcy attorneys tend to do very well during bad economic times.

Another factor is the effect the government can have on the outlook of a business. The imposition of certain taxes or the elimination of certain tax benefits may bear directly on the business's future economic well being. For example, recall that the luxury tax enacted by Congress in the 1980's was designed to tax the wealthy on the expensive cars, boats, jewelry and furs they purchased. The real effect of the tax change was to dramatically reduce the market for these expensive items, which resulted in lower sales by those businesses, driving many to the brink of bankruptcy. (Note: The luxury tax was repealed by OBRA '93).[4] Therefore, the increase or decrease of the taxes assessed against the business may also have a direct effect on its valuation.

3. Book Value of the Business and Its General Financial Condition

The value of the business's assets less its outstanding liabilities results in the business's net worth, or book value. Generally, book value is not a true representation of the business's fair market value since it is based on the historical values of the business's assets and liabilities rather than their current values. If these assets and liabilities are "adjusted" to their current values, the resulting adjusted book value may be a better barometer for valuing the business's liquidation value. The adjusted book value, however, still may not accurately represent the business's true fair market value. The type of business will also dictate how this factor is viewed. Some businesses are asset driven (*e.g.,* manufacturing companies) while others are service driven (*e.g*., professions such as law, architecture, engineering, and accounting). Consideration must be given to the business's other financial data such as its income statement, cash flow statement, and financial ratios as well as its goodwill.

4. Earnings Capacity

This is probably the most important factor in determining the fair market value of a business. It has been said that "everyone knows that the value of (a business)… depends chiefly on what it will earn."[5]

The determination of a business's earnings capacity is not simply its net income. Further, the word capacity indicates future potential of the business's earnings rather

[4] Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, § 13161, 103[d] Cong., 1st Sess. (1993).

[5] *Borg v. International Silver Co.*, 11 F.2d 147 (1925) (Judge Learned Hand).

than its historical earnings. So, how is the business's earnings capacity determined?

Although the future earnings capacity of a business is unknown, the best way to ascertain that capacity is to review the past earnings history of the business. The past history may be the best indicator of future earnings capacity, assuming the external factors (*e.g.,* the economy) and the internal factors (*e.g.,* management and market share) remain constant. However, in examining the business's earnings history, it may be necessary to make a number of adjustments. This may include adding back "excess salary" taken by an owner and "perks" available to officers such as travel, entertainment, company cars and other substantial executive benefits. Further adjustments may be made in regard to the classification of debts owed to the owners as equity contributions, or "loans" to the owners as disguised distributions of profit.

There is no set formula to ascertain which adjustments may be made, since the valuation of any business is dependent on the business's unique factual situation. For example, the "add back" to earnings of what may be categorized as excessive salary may significantly increase the value of the business when utilizing the capitalization of earnings method of valuation. An add back of $50,000 at a capitalization rate of 20% will cause an increase of $250,000 to the business's value.

5. Dividend Paying Capacity

The business's ability to pay a dividend or to distribute profits to its owners is also a factor to be considered in determining the value of the business. The test is not whether a dividend has been or will be paid, but rather the business's capacity to make such a payment. In reviewing the business's ability to pay such dividends, the earnings capacity must be reviewed in relation to expenses of the business and the capital necessary to maintain the business as a going concern with an eye towards growth.

It is well known that closely held businesses rarely pay any dividends, but a business's failure to pay such dividends does not impact the business's ability to pay the dividends. Generally, the profits of a business that could be paid to its owners as dividends pass to them in other forms, such as salary, expense accounts, etc. The astute professional appraiser will review all forms of compensation and perks to ascertain the business's potential dividend paying capacity.

6. Goodwill

Goodwill is the excess value of a business over its normal return on the fair market value of its assets. The business's reputation in the community and its niche in its industry may generate earnings which are not directly attributable to its assets. The valuation of this component is difficult and complex and is best left to a professional appraiser, particularly an appraiser experienced in the specific business being valued.

7. Recent Sales of an Interest in the Business and the Size of the Interest to Be Valued

Any recent arm's-length sale of an interest in the business will be the best indication of the business's overall value. If the sale, however, was a purchase of a partial interest in the business, consideration must be given to the size of the interest purchased in relation to the entire business. A price paid for a 15% interest may not conclusively determine the price for a 60% interest in the business. The price paid for the 15% interest may be net of a minority discount, whether such discount is formally agreed upon or is inherent in arriving

at the purchase price for the 15% interest. The 60% interest may be worth more because it represents a controlling interest in the business. Each recent sale must be compared with the valuation of the entire business on a case-by-case basis to arrive at the true value of the business interest being evaluated.

8. Market Price of Similar Publicly Held Businesses

It is possible that some closely held businesses have competition from other businesses in the same industry which are publicly held. Therefore, reference may be made to those publicly held businesses to assist in arriving at the value of the closely held business. For example, an appraiser may review a public business's financial ratios, such as price-earnings ratio, gross revenue-price ratio, etc., to help determine the value of the closely held business.

Although Revenue Ruling 59-60 has established the factors to be considered in valuing a closely held business, the valuation process is not a science. It is probably true that a group of 20 potential appraisers (which may include accountants, forensic accountants and professional appraisers) given the same financial information may produce 20 different valuations of the business, if not more. The most prevalent manner, however, in which the value of an on-going business (*e.g*,. not a real estate holding company) is ascertained is the capitalization of earnings method, which is discussed below.

Capitalization of Earnings Method

The capitalization of earnings method (CEM) is based on a simple ratio, which consists of an earnings figure and a capitalization rate of return. It is expressed as follows:

Earnings ÷ Capitalization Rate (Expressed as a Decimal) = Business Value

Another derivative of this formula is the earnings multiplied by the price earnings (P/E) ratio:

Earnings x P/E = Value of Business

The P/E ratio, sometimes called a multiplier, is a simple fraction:

1 ÷ Capitalization Rate

These ratios and formulas are well accepted but are only the beginning of a complex journey in valuing the closely held business. The two components of these formulas, earnings and the capitalization rate, may prove to be quite subjective when arriving at the proposed figures.

How to Compute Earnings

There are a number of ways to arrive at an earnings figure to be used in the CEM. The starting point may be the pretax net earnings of the business for the year prior to the valuation date, although its earnings after taxes may sometimes be used depending on the particular business and industry. Generally, three to five years of earnings may be examined to gain a full understanding of the business's profitability over a reasonable period.

The five years of earnings may simply be averaged or the appraiser, after reviewing the financial statements, may notice a trend in the business's earnings. If this is true, a weighted average with more emphasis placed on the more recent figures may be used. For instance, in using a three-year valuation the most recent year would be counted three times, the second year twice and the first year once, with the aggregate sum divided by six. This method places more emphasis on the most recent years and less emphasis on the earlier years.

In determining the earnings for each of the years, it is important to make adjustments for any unusual non-recurring events which may have impacted the earnings. Any extra-ordinary gain or loss should be removed to provide an even-handed determination of the business's profitability. More likely than not, the appraiser will also make numerous adjustments to the business's expenses, such as salary, bonuses, pension plan contributions, loans to and from the owners, travel and entertainment expenses and other "perks." It is easy to see the arrival at an earnings figure for use in the CEM is not a science and is dependent on a number of somewhat subjective adjustments.

The Capitalization Rate

Conceptually, the capitalization rate begins with a rate of return for a "safe investment" such as treasury bonds or certificates of deposit, with a percentage added to reflect the risk associated with an investment in a business. A question normally asked when attempting to determine a capitalization rate is "what rate of return do I desire on my investment in my business, when considering rates of return now available for a 'safe' investment?" For example, if a corporate bond rated AAA is paying a rate of return of 9%, an investor who purchases a closely held business may expect a 15% or 20% return on his or her investment since he or she can safely obtain a 9% return with the corporate bond.

Again, the determination of a capitalization rate is not a science since it is dependent on subjective factors. The risk element of the capitalization rate is determined by the investor's subjective criteria, which encompass the potential earnings of the business measured against his or her proposed investment. Generally, the greater the risk, the greater the reward; the smaller the risk, the smaller the reward. Factors that may be considered in increasing the risk portion of the rates of return may include the size of the business, the number and size of its competitors, its client base (*e.g.*, one major client vs. numerous clients), the current state of the business and the economy, and the future of the business and the economy.

In assigning a risk element to the capitalization rate, an appraiser will review capitalization rates of businesses in the specific industry, noting any recent sales of the businesses in the marketplace. The long-standing practice of the IRS is to establish in its "initial discussion" a capitalization rate of 10%. This figure is not arrived at as a result of an intense evaluation of the economy and the risk factors involved, but rather because it is easy to multiply the earnings figure by ten (1/10). This simplistic approach merely serves as a starting point in the IRS's negotiation regarding the value of this business. The taxpayer's attorney may respond with a significantly higher capitalization rate to rebut the IRS position. The agreed upon capitalization rate and earnings figure are then arrived at via negotiation.

The following chart indicates the higher the capitalization (high risk), the lower the multiplier, which results in a lower valuation of the business, and the lower the capitalization rate (low risk), the higher the multiplier, which results in a higher value of the business. For example:

Capitalization rate	Multiplier (1/cap.Rate)	Earnings	Value of Business
5%	**20**	$100,000	$2,000,000
6%	**16.67**	$100,000	$1,667,000
8%	**12.5**	$100,000	$1,250,000
10%	**10**	$100,000	$1,000,000
12.5%	**8**	$100,000	$ 800,000
15%	**6.67**	$100,000	$ 667,000
20%	**5**	$100,000	$ 500,000
25%	**4**	$100,000	$ 400,000
30%	**3.33**	$100,000	$ 330,000

We have established the concepts necessary to arrive at an initial value of a closely held business based on its financial statements, the state of the economy, and the status of the industry in the general economy and other important factors. Other internal and external factors, however, may be considered in determining the ultimate value of the business. The valuation of a business, like beauty, may lie in the eye of the beholder.

Discounts In General

Once the value of the business is determined by any of the foregoing methods, a qualified appraiser may make additional adjustments to the value. For example, the appraiser in arriving at the value will no doubt begin with the entire value of 100% of the business, as it exists today with all personnel performing their assigned functions. Further, the particular business interest being valued may require adjustments depending on whether it represents a majority interest or minority interest. Additionally, loss of key personnel such as the selling owner may also warrant an adjustment to the value. Last, the simple fact that the business may not be readily sold on the open market will also be considered in adjusting its valuation. These adjustments are most often called discounts.

Lack of Marketability Discount

The valuation of a closely held business may be tricky enough since there is no ready market for the sale of the business. Each business valuation will turn on the individual facts and circumstances (and financial statements) of the particular business. Even when a valuation is completed by a qualified professional appraiser, that is not to say the business could immediately sold at that value like common stock on the New York Stock Exchange. The business must first attract buyer and effect a sale, which may take significant time. Taxpayers, the IRS and, when they disagree, courts, have recognized the applicability of a lack of marketability discount where there is not a ready market for the sale of the business interest. This discount should be applicable to all closely held business interests, whether the business interest is 10%, 30%, 60% or 100%. In *Estate of Andrews v. Commissioner*,[6] the court held that even controlling shares in a non-public corporation suffer from a lack of marketability because of this lack of a ready placement market. In *Estate of Gray v. Commissioner,*[7] the court allowed a lack of marketability discount of 15% on a 82.49% interest being valued. This writer also successfully obtained a lack of marketability discount on a 100% owned subchapter S Corporation. This was accomplished, however, at the IRS appellate level, not the examination division which, of course, initially disallowed any such discount.

Therefore, a lack of marketability discount is inherent in any closely held business. The challenge is to quantify the discount based on the particular facts and circumstances of each case, a job best left to the qualified professional appraiser. These discounts may range from 5% to 70%, particularly when combined with minority discounts, which are discussed below.

Minority Discounts

In addition to the lack of marketability discount available in valuing a closely held business, many times the interest being valued is a non-controlling or a minority interest. The owner of a minority interest generally will have little say in the running of business and is subject to the decisions made by the controlling owner. It is this lack of control

[6] *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982).

[7] *Estate of Gray v. Commissioner*, T.C. Memo 1997-67 (1997).

which allows the application of a discount for valuation of the minority interest.

An example best illustrates the rationale for a minority discount. A closely held C corporation with an established fair market value (before discounts) of $1 million is owned 80% by Vincent and 20% by Elena. It can be argued that Vincent's 80% interest should be valued at $800,000 (before application of a potential lack of marketability discount) and Elena's 20% interest should be valued at $200,000 (again before application of a potential lack of marketability discount). However, Elena's interest should not be valued at the full $200,000 because she has no control over the business and has to abide by the decisions made by Vincent, the 80% owner. No willing purchaser would pay the full $200,000 because of this lack of control in the business. It is for this reason that a minority interest discount would be applicable.

Even the IRS recognizes this discount, stating:

> "The lack of control feature of a minority interest makes it less attractive to investors, who are not necessarily willing to pay the allocable value of the stock. The reduction for what a willing buyer would pay for an interest with no control is called a minority interest."[8]

A minority interest should clearly be available for those interests which are less than 50%. What about an interest which is exactly 50%? In *Wheeler v. U.S.,*[9] the court examined whether a 50% interest in the voting stock of a corporation was entitled to a minority discount. The IRS argued that a 50% interest is not a minority interest and that no minority discount was available. The court disagreed, noting that a 50% interest is not a controlling interest and that a minority interest discount may be applied.

The determination of the minority discount, like the lack of marketability discount, will be made by the qualified professional appraiser. These discounts may run from 10% to 70% depending on the particular facts and circumstances of the business being valued. Obviously, the IRS likes to allow only minimal discounts while the taxpayer seeks substantial discounts. In litigated cases, courts have allowed discounts ranging from 10% to 55%.[10]

Although lack of marketability and minority discounts are separate and distinct in theory, the courts do not always differentiate them. In *Estate of Fleming v. Commissioner*,[11] the taxpayer advocated a combined discount of 35% while the IRS conceded (and the taxpayer did not dispute) only a 10% minority discount. The court determined that a 27% discount was applicable, apparently factoring in the lack of marketability discount. In another case, *Estate of McCormick v. Commissioner*,[12] the court allowed both minority discounts ranging from 18% to 32% and lack of marketability discounts ranging from 20% to 22%, clearly differentiating the discounts.

[8] IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers (1994).

[9] *Wheeler v. United States,* 96-1 U.S.T.C ¶60226 (W.D. Texas 1996), *rev'd on other grounds,* 116 F.3d 749 (5th Cir. 1997).

[10] *See generally Estate of Stoddard v. Commissioner*, T.C. Memo 1975-207 (1975) (court allowed 33 1/3 % lack of marketability and minority discount); *Gallun v. Commissioner*, T.C. Memo 1974-284 (1974) (court allowed a 55% minority interest discount); *Carr v. Commissioner*, T.C. Memo 1985-19 (1985) (court allowed a 25% minority interest discount).

[11] *Estate of Fleming v. Commissioner*, T.C. Memo 1997-484 (1997).

[12] *Estate of McCormick v. Commissioner*, T.C. Memo 1995-371 (1995).

Yet in *Furman, v. Commissioner*,[13] the taxpayer argued for a combined 54.5% discount, with the court determining a 40% combined lack of marketability discount and minority interest discount was applicable. It appears that from the taxpayer's point of view it isn't important how the discount is classified as long as it is applied.

Minority discounts may be available in valuing *inter vivos* gifts of closely held business interests and should be considered as part of gift and estate planning. For example, Pasquale owns 100% of his business and wishes to gift 20% to each of his four sons. Each 20% share is itself a minority interest and should be afforded a minority discount (a lack of marketability discount may also be claimed). Using a hypothetical fair market value of $ 1 million for the business and a combined lack of marketability discount and minority discount of 35%, (as determined by a qualified professional appraiser), Pasquale can gift each 20% interest at a value of $130,000 and not its allocable portion of $200,000, which produces significant gift tax savings. Further, Pasquale's remaining 20% in the business should also be allowed a combined discount in his estate, thus saving estate taxes.

The IRS had argued in the past that business interests owned by recipients of gifts who were members of the same family should be aggregated for purposes of determining control of the business, attempting to avoid the application of a minority interest discount. The IRS lost this argument in *Estate of Lee v. Commissioner*[14] and formally acquiesced in the result of that case in Rev. Rul. 93-12, which stated:

> "If a donor transfers shares in a corporation to each of the donor's children, the factor of corporate control in the family is not considered in valuing each transferred interest for purposes of section 2512 of the Code. For estate and gift tax valuation purposes, the Service will follow *Bright, Propstra, Andrews,* and *Lee* in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest."[15]

The IRS, however, attempted to use this aggregation theory in other cases, particularly those involving QTIP trusts. In *Estate of Bonner v. United States,*[16] the Fifth Circuit Court of Appeals determined that fractional interests in real property and a boat owned by the decedent and a QTIP Trust created for the decedent's benefit by his predeceased spouse could not be aggregated for purposes of their valuation and that fractional (minority) discounts were available, but were to be determined in the district court. In *Estate of Mellinger v. Commissioner*,[17] the court refused to aggregate the shares of Frederick's of Hollywood owned by the defendant in a revocable trust and the shares owned by a QTIP trust set up for her benefit by her predeceased husband. The court applied a

[13] *Furman v. Commissioner*, T.C. Memo 1998-157 (1998) (valuation of gifts of closely held Burger King franchises).

[14] *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

[15] Rev. Rul. 93-12, 1993-1 C.B. 202.

[16] *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996).

[17] *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999).

25% lack of marketability discount to the minority blocks of stocks.

The IRS, however, has mounted other challenges in this area. In one case,[18] a father gifted a 30% interest to each of his three children, taking a combined lack of marketability and minority discount of 25%. The IRS determined that each 30% interest represented a "swing vote" and that any fractional interest discount was offset by this enhancement.

The timing of the creation of the minority interest being valued and the motivation behind the transaction may be critical in successfully obtaining a minority discount. In *Estate of Murphy v. Commissioner*,[19] the decedent, 18 days before her death, transferred .88% of her 51.41% interest in her closely held stock to each of her two children. At her death, the balance of her stock (a 49.65% interest) passed under a power of appointment to a trust for her children's benefit. The clear intention here was to obtain a minority discount, with the court stating that the transfers were made "with the sole and explicit purpose to obtain a minority discount" and, therefore, no minority discount was applicable. Notwithstanding, a 20% lack of marketability discount was allowed.

The IRS has also entertained the notion that the recipient receiving the minority interest must be examined, especially if the recipient is already a partial owner of the business. In one such case,[20] a parent owned 48.59% of the corporation's stock with his son owning the other 51.41% of the corporation's stock. The issue was whether the father's 48.59% minority interest should be valued as a minority interest without reference to the son's ownership in the corporation. The IRS concluded that the valuation would be done without reference to the son's ownership interest in the corporation, and would be valued as a minority interest.

One last consideration in viewing minority discounts is in the gift and estate tax areas. Generally, these taxes are "unified" but some differences exist in the applicability of minority discounts. In the estate tax scenario, let's assume Eduardo owns 100% of his closely held corporation and leaves 10% to each of his ten children at his death. Since each child receives a 10% minority interest, will a minority discount be available? The answer is no. The value of the corporation is included and taxable in his estate at full value (although a lack of marketability or key person discount may be applicable) since he owned 100% of the corporate stock at his death. The estate tax is assessed on the value of property passing at death without regard to who receives it.[21]

However, if Eduardo during his lifetime gifted 10% minority interests to each of his ten children, each gift should be afforded a minority discount. As stated in TAM 9449001:

> "Unlike the estate tax where the tax is imposed on an aggregation of all the decedent's assets, the gift tax is imposed on the property passing from the donor to each donee and it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, where a donor makes simultaneous gifts of property to multiple donees, the gift tax is imposed on the value of each separate gift. Accordingly, the value of property that is

[18] TAM 9436005 (Sept. 9, 1994).

[19] *Estate of Murphy v. Commissioner*, T.C. Memo 1990-472 (1990).

[20] TAM 9432001 (Mar. 28, 1994).

[21] *See generally* TAM 9432001 and TAM 9449001 (Dec. 9, 1994).

the subject of multiple simultaneous gifts may be different from the value of that same property if that property were included in the donor's gross estate at his death."

Therefore, in estate planning it may be more beneficial to gift property prior to one's death to obtain these minority discounts. (Note: in all likelihood, this is only one factor to be considered in determining whether an *inter vivos* gift is appropriate).

It is clear from court cases that success or failure in obtaining favorable discounts for lack of marketability and minority interests is dependent on the effectiveness of the qualified professional appraisers retained by the taxpayer or the IRS. This so-called "battle of the experts" provides the court with the necessary information to decide what discounts may be applied as well as the amount of the discounts. Therefore, it is imperative to retain the services of an experienced professional to bolster one's chances of success in the valuation and discount arenas.

Other Discounts

There are several additional special discounts that may be applicable in valuing certain business interests, all of which will also be determined on a case-by-case basis.

The success of a closely held business is usually dependent on the owner or a small group of key people who have a direct impact on the running of the business. A loss of an owner or key person may adversely impact the continued success of the business and, accordingly, its value. In *Furman v. Commissioner*,[22] the court stated that if a business is highly dependent on one person or a small group of people, the loss of such a key person might precipitate a discount. Key person discounts are particularly applicable to personal service businesses, although they may be applied to other businesses as well. A key person discount would be available where an individual was responsible for all aspects of the business with all decisions made by himself or herself except those of nominal importance.[23]

The rationale for allowing such a discount is that the loss of the "mover and shaker" of the business would adversely affect future sales and profitability because the key person's personal qualities contributed to the success of the business. In those situations, however, where the owner of a business has turned over the day to day running of the business to his or her children, no key person discount would be available.[24]

Another type of discount used in certain cases is the blockage discount. This discount is based on the premise that the sale of the decedent's interest would "flood the market" and thus depress the price of the interest sold. For example, any one piece of artwork by an artist would bring a fair market value price when offered for sale. However, if 425 such pieces were offered for sale at one time, a willing buyer would consider that another 424 pieces of art were up for sale and would not necessarily pay the fair market value price. Rather than value each piece of artwork individually, a better method would be to view the sale of the artwork as a bulk sale. Of course, the IRS did dispute this theory, but after litigation acquiesced in the conclusion by the court that a blockage discount was applicable.[25]

[22] *Furman v. Commissioner,* T.C. Memo 1998-157 (1998).

[23] *Bardahl v. Commissioner*, T.C. Memo1965-158 (1965).

[24] *See generally Estate of Oman v. Commissioner*, T.C. Memo 1987-71 (1987).

[25] *Estate of Smith v. Commissioner*, 57 T.C. 650 (1972), *acq.*, 1974-2 C.B.4, *aff'd on other grounds,* 510 F.2d 479 (2d Cir. 1975), *cert. den.,* 423 U.S. 827 (1975).

A blockage discount may also be applied to publicly traded stock on the same theory. For example, if a shareholder dies owning a substantial number of shares of a public company, *e.g.,* 1 million shares, and the normal number of shares trading daily is 50,000 shares, the release of the 1 million shares would flood the market and depress the sale price. Accordingly, a blockage discount should be available to accurately reflect the fair market value of the shares.

The last discount to be discussed is a relatively new one. It is generally applicable to closely held C corporations that hold highly appreciated assets such as real estate and is called a built-in capital gain discount.

First, let us examine the history behind this discount. In *General Utilities & Operating Company v. Helvering*[26] (hereinafter *General Utilities*), the U.S. Supreme Court held that a distribution of appreciated property to a shareholder as a dividend would not cause the corporation to recognize a gain as a result of the distribution. Therefore, upon liquidation of a C Corporation, any distribution of appreciated property to the shareholders would not result in gain to the corporation, although a shareholder might have to report a gain upon liquidation if the value of the property received was greater than his or her basis. In two subsequent cases, *Cruikshank*[27] and *Piper*,[28] the taxpayers unsuccessfully argued for a discount for built-in capital gain for appreciated property held by the corporation. The courts concluded no built-in capital gain discount was available because there was no intent to liquidate the corporation and the liquidation, if undertaken, could occur without taxing the corporation. Further, the courts held that such a discount was speculative.

In 1986 Congress passed the Tax Reform Act of 1986, repealing the so-called *General Utilities* Doctrine which had allowed the corporation to avoid capital gain taxation on distributions of appreciated property to its shareholders upon liquidation. Accordingly, a corporation which now liquidates must first pay a capital gain tax at the corporate level before distributing its assets to its shareholders.

The IRS position on this issue after 1986 continued to be disallowance of the built-in capital gain discount, notwithstanding the repeal of the *General Utilities* Doctrine. Although no willing buyer would pay the full fair market value for stock of a company holding appreciated real estate knowing a capital gain tax would have to be paid upon the sale of the appreciated asset, the IRS remained steadfast in denying this discount. This writer, in 1995, argued for this discount and was informed that IRS policy was to deny the built-in capital gain discount. It did prove successful, however, to argue that the discount did not have to be called a built-in capital gain discount because it was instead an additional lack of marketability discount, reflecting the price a willing buyer would pay for the stock knowing that a capital gain tax would have to be paid by the corporation. This theory was confirmed in two reported cases in 1998, *Eisenberg v. Commissioner*[29] and *Estate of Davis v. Commissioner.*[30]

In *Eisenberg*, Mrs. Eisenburg gifted stock of a C corporation holding appreciated real estate to her son and grandchildren and claimed a discount for the built-in capital gain. The Tax

[26] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

[27] *Estate of Cruikshank v. Commissioner*, 9 T.C. 162 (1947).

[28] *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979).

[29] *Eisenberg v. Commissioner*, T.C. Memo 1997-483, *vacated and remanded*, 155 F.3d 50 (2[d] Cir. 1998), *acq.*, 1999-4 IRB 4.

[30] *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998).

Court disagreed with this position and an appeal was made to the Second Circuit Court of Appeals, which reversed the Tax Court and held "We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock." The IRS has now acquiesced in this case.

In *Davis*, the court recognized that a willing buyer would consider a built-in capital gain tax in valuing the stock and that it should be taken into account in determining the lack of marketability discount. Again, from the taxpayer's viewpoint it is not as important what the discount is called as long as it is applied to the valuation of the business interest.

Conclusion

As noted throughout this article, the most important aspect of business valuation and potential discounts is the retention of a qualified professional appraiser. There are numerous factors to be considered in making a business valuation, particularly when attempting to arrive at the correct earnings figures and the determination of the capitalization rate. The appraiser must weigh both internal business factors (*e.g.,* key person, type of industry, and financial statements) and external factors (*e.g.,* the economy and regulatory environment) to arrive at the true fair market value after considering any applicable discounts.

Most often these cases are contested at the IRS examination level, at the IRS appellate level, and in court. It becomes a "battle of the experts" in court. Until such time the case is before a judge, however, the true process of determining business valuation and accompanying discounts takes place in the form of negotiation. The IRS and the taxpayer's counsel may have to negotiate the components of earnings figures, the components of a capitalization rate, the value of real estate based on comparable sales, the discounts which may be applied and the value of these discounts. And remember, there is no "right" answer since valuation is an art, not a science.