

Determining Discounts For Lack Of Marketability

The selection and application of an appropriate "discount for lack of marketability" (DLOM) is often key in determining the value of closely held securities. In the practice of law, it is frequently an item of dispute in the context of divorce and in estate settlement.

WHY IT'S SO

At its most basic, DLOM is a percentage reduction of an equity interest's value to reflect the relative absence of marketability — in other words, the inability to quickly convert it into cash at minimal cost.

For two investment instruments identical in all other respects, the market will accord a considerable premium to one that can be liquidated into cash instantly, especially without risk of loss in value.

By its very nature, a minority position in a closely held company, for example, cannot be easily liquidated. These minority members have no access to an active public market and cannot force registration to create marketability. Additionally, such investors would incur more assessment and moni-

toring costs than for an investment in an active public market.

APPLYING THE NUMBERS

In quantifying an appropriate discount, valuation experts typically rely on studies that compare the discounted price of individual restricted or privately transacted securities with the respective securities of the same company that are traded on a free and open exchange.

Restricted stock studies compare the trading prices of a company's publicly held stock sold on the open market with those of unregistered or restricted shares of the same company (i.e., stock for which open market trading is restricted for a period of time).

Pre-IPO studies examine the prices of transactions while the company was still private, compared to the eventual IPO price.

Note that great care and judgment must be exercised in using the results of these studies to estimate the DLOM of a small, privately held company. Restricted stocks, by definition, are stocks of companies that already trade on the open market. When the restrictions are lifted or expire, an active and efficient market for the formerly restricted shares immediately exists. This is simply not true for privately held companies. For the pre-IPO studies, in many cases the buyers and sellers were aware of the possibility of future marketability.

APPLYING CURRENT THINKING

A case study, based on an actual recent IRS Estate Examination, highlights how careful application of current case law can have a profound impact on calculation of DLOM.

The case involved two Family Limited Partnerships funded in

large part with marketable securities and real estate. Citing various empirical studies all dealing with restricted stock, the IRS pushed for a lower valuation discount (in the 15 percent range). The estate was able to successfully argue for a higher valuation discount (in the 25 percent range), citing *Okerlund v. United States*, 53 Fed. Cl. 341, 2002 U.S. Claims, in which the Court ruled that it was proper to use pre-IPO studies in calculating DLOM.

The overall planning result: tax savings of some \$1.5 million to the estate.

HOW IT PLAYED OUT

As the issue played out over several years, the IRS initially argued for a lower DLOM based on data from studies on the value of restricted stock.

At the IRS Appeals Office level, the estate was able to establish a larger valuation discount by citing empirical data from pre-IPO studies in the wake of *Okerlund v. United States*. The discounts computed under this method are typically larger than those utilizing restricted stock studies due to the fact that the original shares were privately transacted with no anticipation of access to a public market, not just restricted for a period of time. (Or, looking at it another way, discounts for restricted stock are lower because they reflect a public market once the restrictions lapse.)

BOTTOM LINE

In the end, a valuation professional cannot simply apply the average or median discounts found in the studies, but must analyze the characteristics of the subject company. Only after a reasoned analysis can an appraiser determine a rational and supportable DLOM. ❖

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