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FAIR VALUE™

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MARKETABILITY DISCOUNTS- THE *MANDELBAUM* CASE RAISES KEY ISSUES

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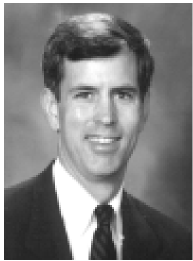
Bernard Mandelbaum, et al v. Commissioner of Internal Revenue (T.C. Memo 1995-255, June 12, 1995)

Introduction. As the September, 1994 issue of *Fair Value*™ discussed, the discount for lack of marketability (marketability discount) is widely recognized and accepted by courts, valuation experts, and the IRS as the "cost" of the lack of liquidity inherent in the stock of companies for which there is no ready market for the shares. Estate tax advisors are frequently heard to say that it is "safe" to take a 30% to 40% discount for lack of marketability. But is it? While U.S. Tax Court ended up at a 30% discount in the *Mandelbaum* case, this should not be room for encouragement of the efficacy of using such a discount. The Court reached its finding after taking square aim at the idea of a standard range of discounts and the reliance on study findings alone, and enunciated key issues which should enter into the reasonable estimation of an appropriate discount.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Background. At issue was the proper marketability discount to apply in the fair market value of the stock of Big M, Inc. (Big M) a privately-held, family-owned S corporation located in New Jersey. The company was founded by three Mandelbaum brothers, who were all equal shareholders until 1976, when the brothers began to transfer shares to their children. The company had two classes of stock, voting and non-voting.

Big M operated in the women's apparel retail industry, with stores along the north and central eastern coast. All three brothers and their children are actively involved in the business. As of 1990, the company had 122 stores. A shareholders' agreement was in effect, providing the corporation with the right of first refusal. No formula for determining the transfer value was incorporated in the shareholders' agreement.

Gift tax returns were prepared by the corporation's usual accountants, who also valued the stock. As the freely-traded values of the stock were stipulated to at trial, the only issue was the proper discount for lack of marketability, which the IRS expert placed at 30%, and the family's expert placed at 70-75%.

Marketability Studies Considered by the Experts. Both experts supported their determination of the marketability discount based upon studies which we detailed in our September, 1994 issue of *Fair Value*™. The studies can be categorized as follows:

Restricted stock studies - where the only difference between the restricted stock of a public company and its unrestricted stock is that the restricted stock is prohibited from sale on the open market for a definitive period, normally two years. The three studies considered by the IRS expert were the **SEC Institutional Investor Study**, the **Moroney Study** and the **Maher Study**, which had median discounts of 33% (for the first two) and 35%. The family's expert also considered these three studies, as well as the following:

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Gelman, Trout, Pittock & Stryker and Williamette Management Associates. The combined seven studies had a median marketability discount of 35%.

Initial Public Offering Studies - IPO studies report the difference between the sale prices of stocks in IPO's and the sale prices of the same stocks in private sales occurring shortly before the public transactions. The three studies analyzed by the family's expert were **Emory-1985**, **Emory-1986,** and **Willamette Management Associates**. The IPO studies found average marketability discounts of 45%.

The family's expert also interviewed a number of investment firms to determine the rate of return required for an investment in a company like Big M. The expert concluded that the required rate of return for an investment in Big M would be 35 to 40%, and that an investor would have to hold his or her stock for 10 to 20 years.

The Court's Examination of the Experts. The Court was not persuaded by either expert. The IRS expert did not give enough weight to the transferability restrictions in the shareholders' agreement and relied too heavily on the restricted stock studies of public companies with a holding period of two years, where Big M was a privately-held company with a probable holding period exceeding two years.

The family's expert did not assume a willing buyer and a willing seller because a willing seller would be unlikely to accept a 70% discount on his or her shares. The family's expert gave too much weight to the shareholders' agreement. The Court stated that the right of first refusal has little, if any, effect on fair market value. It merely governs the order in which prospective buyers must stand in line to buy the stock. The Court also felt that the family's expert should have interviewed investors other than venture capitalists, LBO groups and merchant bankers, who require a higher rate of return than other investors. The Court also did not accept to 10 to 20 year holding period because the family's expert did not explain the connection between the holding period and the time to retirement of the next generation of family management.

Factors Considered by the Court In Determining the Proper Marketability Discount. The Court enunciated the following salient factors it said should be considered as relevant in determining the appropriate discount for lack of marketability:

1. *Private vs. public sales of the stock* - This factor was considered by analyzing the sales of similar interests in like companies via the marketability studies discussed earlier. The Court found the 10 studies examined by the family's expert to be more encompassing than the 3 studies analyzed by the IRS expert. Since the restricted stock studies examined by the family's expert had an average marketability discount of 35% and the average discount for the IPO studies was 45%, the Court used these two figures as benchmarks.
2. *Financial statement analysis* - Specific items mentioned in this factor include the results of annual operations, status at year end as determined by the balance sheet, relevant footnotes, the opinion of an independent CPA, the soundness of the company's capitalization, the ratio of the company's assets to liabilities, net worth, future earnings power, quality of earnings, and the company's goodwill.
3. *Company's dividend policy* - Critical to this factor is whether the investor will receive a fair return on his or her investment. The fact that a company pays little or no dividends may not always affect the company's marketability, as an investor may aim for capital appreciation instead of dividend income.
4. *Nature of the company, its history, position in the industry and its economic outlook* - Obviously the position of a company in its industry, and the factors needed for success in the industry need to be considered when determining the value of a company. The stock of a market leader will usually be determined to be more valuable than that of a market laggard.
5. *Company's management* - Strength of company management is a factor to consider when determining the worth of a company's stock. A proven and experienced management team may positively affect a company's value.
6. *Amount of control in transferred shares* - Control reflects a shareholder's ability to direct a corporation in its daily operations. Control of a closely-held corporation represents an element of value that justifies a higher value for a controlling block of stock.
7. *Restrictions on transferability of stock* - Shareholders' agreements, as enforceable legal documents, are a factor in determining the worth of a company's stock. Whether an agreement specifies a transfer price or a formula for determining a transfer price are important factors for consideration.
8. *Holding period for stock* - An investment is less

marketable if an investor must hold it for an extended period of time in order to reap a sufficient profit. Market risk increases and marketability decreases as the holding period gets longer.

9. *Company's redemption policy* - Whether a company has the right to purchase its stock before it is sold to an outsider is another factor to consider when determining the value of a company. This may be particularly critical if the redemption agreement sets a price on the stock.
10. *Costs associated with making a public offering* - An above average discount may be warranted if the buyer completely bears the cost of registering a private stock. The discount is lessened if the buyer can minimize his or her registration costs.

The Court's Conclusion. The Court considered each of the above ten factors. Based upon Big M's history of earnings growth, strong capitalization, sufficient cash reserves, position in the industry, a proven management team, the restrictions in the shareholders' agreement, and the company's redemption policy, the Court determined that a 30% marketability discount was to be applied for all valuation dates.

The IRS then attempted to impose underpayment penalties on the family under IRC section 6660 and section 6662. The Court denied the penalties because the family reasonably relied on the expertise of their business valuation professionals, as displayed by their manner, education and experience, and the family reported the valuation to the IRS in good faith.

The Bottom Line. The importance of hiring a professional valuation firm skilled in the application of the above marketability factors with a thorough grounding in the studies previously mentioned should be readily apparent. Using a valuation professional with the requisite education and experience may also avoid any later action by the IRS, and possibly eliminate the imposition of substantial penalties. Whether the *Mandelbaum* case is the beginning of a trend or is an isolated circumstance remains to be seen. Yet, it provides valuable insight into the Court's desire (at least in this case) to go beyond the simple acceptance of marketability discount study results and require of the taxpayer and valuation professionals a convincing and detailed analysis of the actual factors that impact marketability, items which are unique to each circumstance. ♦

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