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THE 35% "STANDARD" MARKETABILITY DISCOUNT: R.I.P.

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Young Pup: *I am valuing shares in this privately-owned company but I don't know what kind of marketability discount is appropriate.*

Michael Paschall

Old Dog: *Just do what I have always done – take a 35% discount and move on. That's what the studies say and that's the standard discount – everybody uses it.*

Young Pup: *But this company—*

Old Dog: *—doesn't matter. Just use the 35%.*

Introduction

Recent decisions by the U.S. Tax Court have reinforced the current trend in business valuation that a blind application of a marketability discount will no longer fly and you better make sure your business appraiser can support his or her discount. These decisions indicate an unprecedented level of scrutiny and are consistent with an overall movement by the courts to a far closer examination and analysis of the assumptions made in business valuations and the increasing tendency to select the value that is better-supported and not just split the difference between the two experts. And it is not just the courts that are increasing their scrutiny of valuation reports – so too are clients and users of valuation reports in other contexts – litigation, transactions, corporate, ESOPs, bankruptcy, and other areas. This article will focus primarily on the issue of supporting marketability discounts, however, the overall lesson to be learned here (i.e., solid rationale and reasonable assumptions) applies to all aspects of a valuation report.

The Marketability Discount

Before we look at the recent line of cases, it is necessary to briefly examine the concept of a marketability discount and the various sources from which marketability discounts for minority interests are derived. The concept of a marketability discount is quite simple. Because a privately-owned or closely-held company has no public market for its stock, some discount to account for this lack of ability to easily liquidate the interest is usually (but not always) warranted. In contrast to publicly-traded stock (which is easily sold with a telephone call to your broker), there may be a far more limited avenue of liquidity to the private-company shareholder, if any such avenue exists at all. A marketability discount, therefore, is usually appropriate to "compensate" the holder of the private-company interest for the fact that he or she cannot easily sell the interest, or perhaps cannot sell it at all. Marketability discounts, however, do not apply in every situation. A discussion of some of the most common misuses of marketability discounts is contained later in this article.

Restricted Stock Studies

The first major type of marketability study is the restricted stock study. There are a number of published restricted stock studies, all of which use basically the same analysis. In its most basic form, restricted stock is publicly-traded stock that is restricted from trading on a public exchange for some period of time. One typical situation in which restricted stock may arise is when a seller sells his company to a publicly-traded company and takes a large block of restricted stock back as consideration for the sale. Another typical situation can be when an investor buys a large block of a publicly-traded company's stock. Because the publicly-traded company does not want these new shareholders to sell all of this stock on the public market at one time (potentially depressing the stock price), such stock may be restricted. A typical period of restriction (under the SEC's Rule 144) is one year, although the typical restriction period used to be two years. Furthermore, after the restriction period, there typically are volume restrictions that limit the amount of shares that can be sold publicly.

Just because a publicly-traded stock is restricted as described above, however, does not mean it cannot be sold in a private transaction. Owners of restricted stocks can and do find buyers for their restricted stock, however, it is at a price that is less than the publicly-traded price due to the fact that the restricted stock cannot yet be sold in the public market. For example, suppose the unrestricted, publicly-traded stock of a company is trading for $10 per share. The owner of restricted stock in that same company may only be able to find a buyer for his stock at $7 per share, a lower value due to the unfavorable restrictions on the stock. A restricted stock study takes this data and calculates a 30% discount (the difference between the $10 publicly-traded price and the $7 price at which the seller was actually able to sell the restricted stock to a buyer). Because there are no differences between the two stocks (other than the restrictions), the 30% difference between the two values has to be due entirely to the lack of marketability of the restricted shares.

Initial Public Offering (IPO) Studies

The other major type of marketability study is the IPO study. There are several IPO studies, however, the most widely-cited study has been done by the same authors in nine separate two- or three-year periods over the 1980 to 2000 time frame. This IPO study calculates the difference between the pre-IPO, private-market trading price of closely-held companies with the actual IPO stock price of the company. For example, suppose the owner of stock in a privately-owned business sells his stock for $6 per share to a buyer. Later, that same company goes public in an IPO at a value of $10 per share. The IPO study takes this data and calculates a 40% discount (the difference between the $10 IPO price and the $6 price at which the seller was able to sell the then-privately-owned stock to a buyer). Again, because there are no differences between the two stocks (other than the public trading market as of the IPO date), the 40% difference between the two values has to be due entirely to the lack of marketability of the pre-IPO shares.

A Look at the Cases

In three recent Tax Court cases, the taxpayer came in with a "standard" 30% to 35% marketability discount based on the "standard" marketability discount studies, however, the court in each case found fault with the taxpayer's analysis and ultimately held for a lower marketability discount. A brief synopsis of the facts and holding of each case follows.

Strike One!

In *McCord v. Commissioner,* 120 T.C. 358 (2003), the entity at issue was a family limited partnership (FLP) that held a combination of real estate and marketable securities. In his analysis, the taxpayer's expert analyzed four restricted stock studies and took a 35% marketability discount based on those studies. The expert for the IRS relied on his own studies of private placements and selected a far lower 7.2% marketability discount.

The *McCord* court rejected the 35% marketability discount of the taxpayer's expert, stating that the restricted stock studies cited by this expert were not applicable to the FLP at issue. The *McCord* court believed that the marketability data from the IRS' expert was more reliable, however, the court took issue with that expert's stratification and selection of his data, noting that this expert had selected his discount from the lowest of his three stratified groups. The *McCord* court examined the aspects of each stratified group of the IRS' expert's data and ultimately determined that a 20% marketability discount was appropriate. Moral of the story: the taxpayer's expert's selection of a 35% discount based on restricted stock studies (which he had probably done hundreds of times before) was flat-out rejected by the Tax Court as being inapplicable to the entity at hand in this case.

Strike Two!

In *Lappo v. Commissioner,* T.C. Memo. 2003-258, the entity at issue was a FLP that also held a combination of real estate and marketable securities. In his analysis, the taxpayer's expert relied on a private placement study with an average marketability discount of 29%. The taxpayer's expert, however, ultimately selected a higher 35% marketability discount due to what he believed were unfavorable comparisons between the FLP in this case and the companies that were the subject of the private placement study. The expert for the IRS (the same one as in *McCord*) again relied on his own studies of private placements and selected a far lower 7.2% marketability discount.

As did the *McCord* court, the *Lappo* court flatly rejected the higher discount by the taxpayer's expert and again focused on the marketability studies utilized by the IRS' expert. In analyzing this data, the *Lappo* court noticed a central tendency of a 20% marketability discount and ultimately allowed a 24% marketability discount due to certain unfavorable characteristics of the FLP at issue.

Strike Three!

Finally, in *Peracchio v. Commissioner, T.C. Memo. 2003-280*, the entity at issue was a FLP holding a combination of marketable securities and cash. The taxpayer's expert cited a number of restricted stock studies and took an average marketability discount of 30%. The expert for the IRS "arbitrarily selected" (according to the court) a 15% marketability discount.

The *Peracchio* court, unimpressed with either expert, was left to conduct its own marketability analysis. Citing the discount analysis framework provided in the *Mandelbaum* case (*Estate of Mandelbaum*, T.C. Memo 1995-255, June 12, 1995), the *Peracchio* court stated that while restricted stock studies do have probative value, the taxpayer's expert here made no attempt to analyze the data from these studies to determine their applicability to the FLP at issue. The *Peracchio* court stated that there are fundamental differences between an asset-holding entity such as a FLP and the operating companies that are the subject of the restricted stock studies. The IRS expert in *Peracchio* did not present any marketability discount data for the court to analyze, therefore, in considering comments by the IRS expert that the IRS would concede a marketability discount up to 25%, the court allowed a (surprise!) 25% marketability discount.

You're Out!

Therefore, in the *McCord, Lappo,* and *Peracchio* trilogy, we see the taxpayer's expert in all three cases use the "ol' reliable" marketability discount studies and marketability discounts yet have the court throw it out each time in favor of what it believed was a more relevant analysis. Granted, the taxpayers in *McCord, Lappo*, and *Peracchio* did not suffer a crushing defeat in each case: the McCord taxpayer asked for a 35% marketability discount and got 20%, the *Lappo* taxpayer asked for 35% and got 24%, and the Peracchio taxpayer asked for 30% and got 25%. All in all, the taxpayers fared far better than the IRS which asked for 7.2%, 7.2%, and 15%, respectively. Yet the troubling factor for the taxpayer's expert in these cases is that the standard marketability studies and standard marketability discounts cited were deemed inapplicable to each respective situation.

Asset-Holding Companies Versus Operating Companies

One key similarity in the *McCord, Lappo,* and *Peracchio* line of cases is that all three entities in these cases were asset-holding entities (i.e., FLPs) as opposed to operating companies. Indeed, as seen above, the *Peracchio* court scolded the taxpayer's expert in that case for blindly applying the data from the restricted stock studies (which are based on operating companies) to the asset-holding entity that was the subject in the case. It is important to distinguish that the *Peracchio* court did **not** say that the application of the restricted stock studies to the asset-holding company was incorrect per se. The *Peracchio* court found fault with the fact that the taxpayer's expert made no effort to **distinguish** the differences between the operating companies of the restricted stock studies and the asset-holding company at issue. In other words, the *Peracchio* court implies that it is acceptable to use the restricted stock studies to determine a marketability discount for an asset-holding company, however, the expert must note and analyze the differences between operating companies and asset-holding companies and support any implications that has on the ultimate marketability discount selected.

In fact, in another 2003 Tax Court case (*Green v. Commissioner*, T.C. Memo. 2003-348), the company at issue was an operating business (a bank holding company). The taxpayer's expert in *Green* took a 40% marketability discount based on restricted stock studies. The expert for the IRS in *Green* cited one particular restricted stock study which had an average discount of 30%, however, the IRS expert ultimately took a 25% discount due to various favorable aspects of the Company. The *Green* court cited the restricted stock study used by the IRS expert, but determined that the private company at issue compared less favorably than the stocks that were the focus of that study and therefore allowed a higher 35% marketability discount than was proposed by the expert for the IRS.

Thus we see a couple of things in *Green*. First, when presented with two marketability analyses, the court again conducted its own marketability analysis and ultimately came up with a different marketability discount. Neither expert in *Green* was able to present a marketability analysis compelling enough for the court. And secondly, the *Green* court allowed a higher 35% marketability discount for this operating company than the 25% to 30% discounts allowed in the three asset-holding company cases examined earlier. Operating companies do not always warrant higher marketability discounts than asset-holding companies, however, and the implications of the higher marketability discount for the operating company in *Green* as compared to the lower marketability discounts for the asset-holding companies in the previous three cases should not be accepted as a ironclad rule of business valuation.

Implications of the Studies

The key lesson to take from these cases is the importance of understanding the various marketability studies, how they relate to the particular entity and interest being valued, and whether the ultimate marketability discount that is reasonable for the situation is below, equal to, or above the discounts (or range of discounts) suggested by the studies. There are a number of key implications to consider in reviewing the restricted stock and IPO marketability studies, a couple of which are discussed as follows.

Private Company Stock may be "Restricted" for a Very Long Time

The stocks that are the subject of the restricted stock studies are restricted for a period of either one or two years. Most of the restricted stock studies were done during the period when the restriction from public sale (under Rule 144) was for two years. This period was later shortened to one year. In either case, the owner of restricted stock is guaranteed liquidity after the expiration of the restriction period (subject to volume restrictions). In contrast the stock of many privately-owned companies may be effectively restricted from any kind of sale for a much longer period through the lack of any viable market or anticipation of any such market. The implication of this analysis is that the stock in many privately-held companies is less marketable than the restricted stocks that are the subject of the restricted stock studies and therefore should warrant a higher marketability discount. **This is not to say that the marketability discount for stock in a privately-held company should automatically be higher than the discounts seen in the restricted stock studies,** however, it is one issue (among many) to consider.

Private Company may Never Go Public

The stocks that are the subject of the IPO study are of companies that obviously have the requisite size, management depth, business plan, and investor appeal (among other attributes) necessary to go public. In contrast, many privately-held companies have none of these attributes and have virtually no chance of going public. The implication of this analysis is that the stock in many privately-held companies is less marketable than the pre-IPO stocks that are the subject of the IPO study and therefore should warrant a higher marketability discount. **Again, this is not to say that the marketability discount for stock in a privately-held company should automatically be higher than the discounts seen in the IPO stock study,** however, it is one issue (among many) to consider.

Common Mistakes Made in the Marketability Discount Analysis

As implied in the hypothetical dialogue at the beginning of this article, some valuation practitioners make the mistake that the same marketability discount applies in all situations, however, this is simply not the case. "Cookie cutter" marketability analyses and applications are a significant valuation error we see repeated frequently in the reports we are asked to critique. Some of the more common errors we see repeated in these reports are discussed as follows.

Nature of the Company (Operating vs. Asset Holding)

This issue is illustrated in the *McCord*, L*appo*, and *Peracchio* line of cases discussed in more detail above. As shown in those cases, a direct application of the data from restricted stock and IPO studies (which are based on operating companies) to an asset-holding company will not necessarily be accepted on its face without additional analysis supporting why such data is relevant (or how it is different) from the asset-holding company at issue.

Controlling Interests vs. Minority Interests

The two major types of marketability studies (restricted stock and IPO) are based on MINORITY interests in companies and therefore are considered when valuing minority interests in privately-owned companies. It is amazing how many valuation practitioners erroneously apply a 35% marketability discount to a controlling interest in a privately-held company based on these studies. In most cases, a controlling interest is far more marketable than a minority interest and therefore warrants a lower (if any) marketability discount. There are several other sources of objective data on marketability discounts for controlling interests that can be analyzed and applied to a controlling interest in a company. This analysis results in an apples-to-apples comparison instead of the oranges-to-apples comparison mistakenly used by many business appraisers.

Failure to use *Mandelbaum* or Similar Analysis

Many valuation reports contain page after page of company information, economic data, ratio analysis, explanations of the valuation methodologies, and details of the various marketability discount studies. Then, after all of this, the valuation report states something to the effect of “a 35% marketability discount was deemed appropriate in this case” and that’s it. Or, “based on our opinion and experience, a 35% marketability discount was warranted” (yet no analysis is offered). Translated, this means: “we have been taking the 35% discount for years and see no reason not to do it here too.” There is no analysis whatsoever of WHY the 35% discount was the appropriate discount. There is no discussion of the relevant factors that were considered in determining the 35% marketability discount. It’s just “35% and done.” Some appraisers apparently believe that if you regurgitate enough statistical data on the various marketability studies beforehand, the reader of the report will be bludgeoned into believing that you must know what you are talking about and the 35% discount you select therefore has to be valid. As seen in the cases previously examined in this article, however, this is a very dangerous strategy to assume.

In the 1995 *Mandelbaum* case, the Tax Court outlined a detailed ten-step analysis it required in determining the marketability discount for the company at issue in that case. Although an exact *Mandelbaum* analysis is not necessarily required in each case, a similarly-detailed analysis must be conducted for the valuator to estimate the appropriate marketability discount and to also communicate the reasons for the selection of that discount to the reader of the valuation report. The factors noted in *Mandelbaum* include the following issues:

1. Private vs. public sales of the stock.
2. Financial statement analysis.
3. Dividend policy.
4. Nature of the company, history, position in the industry, and economic outlook.
5. Management.
6. Amount of control in transferred shares.
7. Restrictions on transferability of stock.
8. Holding period for stock.
9. Company’s redemption policy.
10. Costs associated with making a public offering.

This is by no means an exhaustive list. An analysis of these and other factors can have a key influence on the selection of the appropriate marketability discount.

Double-Counting

Many valuation practitioners apply the same marketability discount to each and every preliminary estimate of value in the report, no matter what the underlying valuation methodology. This is incorrect as it raises the very real possibility that the appraiser is double-counting the marketability discount.

For example, suppose an appraiser utilizes the merged and acquired company method in his valuation report of a 100% controlling interest in a company. The merged and acquired company method considers multiples paid for other similar companies and then applies those multiples to the private company at hand to derive a value. Suppose this appraiser comes up with a preliminary estimate of value of $1 million for a 100% controlling interest in a business, before any discounting. This business appraiser is savvy enough to know that no minority discount is appropriate here (because this is a 100% controlling interest), however, suppose this appraiser applies a 15% marketability discount to the $1 million value, justifying a lower discount (compared to the “standard 35%”) as appropriate due to the fact that a 100% interest is at issue.

Although this appraiser may appear to be correct, he likely has double-counted his marketability discount and undervalued the company. This is due to the fact that the transaction prices of the 100% controlling interests observed in the merged and acquired company method already incorporate some degree of lack of marketability based on the fact that these companies were privately-held companies to begin with. Whatever price was paid for each of the companies in the merged and acquired company method already reflects any discount assigned by the buyer for the fact that he or she was buying an illiquid, privately-held company. Unless there are specific factors about the private company being valued that make it less marketable as compared to the companies observed in the merged and acquired company method, no marketability discount should be applied. In fact, if it can be determined that the subject private company is more attractive than the companies observed in the merged and acquired company method, some marketability premium may be appropriate.

The same double-counting error can be made in valuing an asset-holding company with some real estate component. Should an appraiser first apply a discount to net asset value based on real estate limited partnerships and then apply a full marketability discount on top of that, the appraiser may have failed to consider the fact that the discount to net asset value seen in the limited partnership market may already contain some component for the fact that the limited partnership re-sale market has more limited liquidity than the traditional public stock markets such as the New York Stock Exchange or NASDAQ.

Trapped-in Capital Gains

The valuation impact of low-basis, high-value assets (which, if sold, would trigger a capital gain) were generally ignored prior to 1998, however, a recent line of cases has given support to the application of discounts for such "trapped-in" (or "built-in") capital gains. A business appraiser who fails to consider the impact of this issue may overvalue the company. For a more detailed treatment of this issue, please see "Valuation Discounts for Potential Capital Gains: How Much is Enough?" "Dunn Court Allows Discount for Built-in Gains – Hope for Estate Planning (And Avoiding Inequitable Outcomes in Equitable Distribution," and "Discounting for Built-in Capital Gains in LLCs, Partnerships, and S Corporations" at www.businessvalue.com (click on the Valuation Articles tab).

Summary

In conclusion, courts, attorneys, clients, and all users of valuation reports are becoming more educated and more sophisticated in their analysis of assumptions made and positions taken in these reports. As a result, the old days of taking the "standard" 35% marketability discount and going happily on your way are gone. In all areas of business valuation, marketability discounts (and, indeed, all valuation assumptions) are coming under increasing scrutiny and challenge. Unless the business appraiser has developed a sound, reasonable, and relevant analysis of and for the situation at hand, the risk of having the rug pulled out from under you is now greatly enhanced. Make sure your appraiser and appraisal are on solid ground. ♦

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