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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. 2000-3

The Davis Case

Part Three (B) of Three

by John A. Thomson, ASA, MAI

IN THIS ISSUE…

In this final section of our write-up on the Davis Case (3B) we concentrate on the issue of marketability discounts including consideration for built in capital gains tax.

A discount for marketability (lack of liquidity) is generally applicable on a minority interest in a closely held (non-publicly traded) company. An investor in publicly traded securities (such as closed-end funds) enjoys relatively good marketability and may readily liquidate his or her investment in a relatively short period of time, should this be desired. An investor in securities of closely held companies does not enjoy this same degree of liquidity or marketability and, therefore, would require additional consideration as off setting compensation, or a discount for lack of a ready market.

A discount for marketability is generally applicable on a minority interest in a closely held company.

Discounts for lack of marketability take into consideration, the dispersion of the company's stock among existing shareholders, the size of the block of stock being appraised, restrictions on the sale of the stock to third parties, the company's financial strength, the company's potential to pay dividends, and other factors of marketability. In essence, the marketability discount for a minority interest represents a discount for the degree of absence of the liquidity afforded by a public market. In the Davis Case, the discounts for up front, built in capital gains and lack of marketability were as follows:

	Tax Payer Expert #1 Howard	Tax Payer Expert # 2 Pratt	IRS Expert KTS(Thomson)	Tax Court Decision
Built in Capital Gains (up-Front)	31.1%	0%	0%	0%
Marketability Discount	35.0%	50.0%	38.0%*	41.0%

*included 15 percentage points for built in capital gains

We (KTS) considered and discussed the following factors in our report as being relevant to help quantify the marketability discount.

1.The size of the equity interest and its ability or lack of ability to influence management decisions.

2.The dispersion of the remaining equity interest.

3.The public awareness or exposure of the business or assets.

4.The type of business and composition of assets, and the relative attractiveness of the business' assets.

5.The financial strength of the company and it's potential for paying dividends.

6. The basis of value and method of value used to determine asset value.

7. Any other relevant factors which can influence this discount.

We utilized five (5) commonly used restricted stock studies (SEC, Gelman, Trout, Morony and Maher) to determine our base marketability discount. The overall range of average discounts for the studies was 26.4 to 35.6 percent. We used as our base discount the range of 33.0 to 36.0 percent before any adjustments for the above noted seven factors. The taxpayer's expert used the same restricted stock studies but also included two initial public stock offering studies (IPO studies) dated 1993 and 1995, even though the date of valuation was 1992. The judge pointed out that we (KTS) should have considered these studies if the raw data incorporated in the studies would have been available as of 1992. The judge did not say we had to give any weight to the studies, merely that we should have considered them.

The subject gifts were two (2) 25.77 percent interests. After the gifts were made, no one shareholder had

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THE DAVIS CASE (Cont.)

control. The father had 48.46 percent and each of the two sons had 25.77 percent. We adjusted our starting base range of marketability discount of 33 to 36 percent down to 23 percent based on the subject size and the previous first six (6) factors.

Factor seven (7) became built in capital gains. To date (as of the Davis Case) no consideration had been given to built in capital gains by the tax court unless the liquidation of the "C" corporation and/or it's assets was imminent. Another key point to remember is that the subject corporation was a "C" corporation and it held a publicly traded stock (Winn Dixie) with a tax basis of $338,283 and a fair market value of $70,043,204, resulting in a severe case of built in capital gains exposure. For those unfamiliar with "C" corporation status, capital gains tax is paid first at the corporate level, then the proceeds are taxed at the shareholder level if the proceeds are to be distributed to the shareholders (owners). This results in a double tax on the built in gain. Ninety percent (90) of the Net Asset Value (NAV) was therefore subject to the double tax if the Winn Dixie stock was sold by A.D.D. or if the corporation (A.D.D.) liquidated. This is a factor a willing buyer would certainly consider before purchasing any of the subject stock in A.D.D. (a "C" corporation asset holding company).

As in every case, the specific facts and circumstances are very important.

In an attempt to quantify what the consideration for built in capital gains should be, we analyzed eight (8) general closed end equity funds and compared their built in capital gains exposure to their discount from their NAVs. The built in capital gains exposure ranged from 16.5 percent of NAV to 51.3 percent. The closed-end fund with the highest built in capital gains exposure had one of the lowest discounts. In other words there appeared to be no direct correlation, at least up to 51 percent of net asset value, that with higher exposure to built in capital gains the investors discounted NAV more than without the exposure. However, this discount on the closed-end funds is primarily driven by minority interest issues as opposed to marketability issues. Common sense would suggest that, at 90 percent of NAV, some discount would be considered by a prudent "willing buyer." In this particular situation, we chose to give dollar-for-dollar consideration above the 51 percent which was the high-end of the closed-end funds and showed no correlation. Therefore, we stated that no consideration should be given for the first 51percent of NAV that was exposed to capital gains, but full consideration for any exposure above 51 percent, which, in this case, was approximately 39 percent (90 percent - 51 percent). This tax when compared to the overall NAV equated to 15.0 percent (rounded). This 15.0 percent was our factor 7 (built in capital gains) which we added to our marketability discount for the other six factors of 23 percent to derive a total marketability discount with consideration of built in capital gains of 38 percent. The court eventually decided this discount should be 41 percent. As in every case, the specific facts and circumstances are very important.

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Summary of Adequate Disclosure Regulations

by

Gary L. Schroeder, ASA

For this issue, as stated in our previous newsletter, we are providing a summary of the "Adequate Disclosure of Gifts" regulation which was passed on December 3, 1999. The Internal Revenue Code Section 6501(c)(9) states that the period of limitations (usually 3 years) on the assessment of a gift tax will only start running if the gift is adequately disclosed on the gift tax return. The final regulations provide information that is necessary to satisfy the adequate disclosure rule.

This information includes:

(i) A description and any consideration received by the transferor;

(ii) The identity of, and relationship between, the transferor and each transferee;

(iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust or a copy of the trust instrument;

(iv) A detailed description of the method used to determine the fair market value of property transferred, including financial data, descriptions of restrictions and discounts considered or used; and

(v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

The requirements cited under number (iv) above (will be satisfied according to the regulations) if a

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Summary of Adequate Disclosure Regulations (Cont.)

properly prepared appraisal is submitted. The appraisal must meet the following requirements:

(i) The appraisal is prepared by an appraiser who satisfies all of the following requirements:

(A) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.

(B) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued.

(C) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and

(ii) The appraisal contains all of the following:

(A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

(B) A description of the property.

(C) A description of the appraisal process employed.

(D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

(E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

(F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

> ...it has become even more important to hire a qualified, independent appraiser to perform any valuations of closely held stock that is gifted...

(G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

(H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

As can be seen above, it has become even more important to hire a qualified, independent appraiser to perform any valuations of closely held stock that is gifted, and to make sure before the appraiser is hired that the report will be detailed enough to satisfy the above requirements.

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KTS Adds to Professional Staff

Klaris, Thomson & Schroeder, Inc. is pleased to announce that Philip M. Reynolds, CPA, CVA, has joined the company in our Washington D.C. area office.

Mr. Reynolds specializes in the valuation of privately-held businesses. Mr. Reynolds has valued businesses in a variety of industries, including medical care, general retail, wholesale lumber, computer services, construction, machine parts, beverages, manufacturing of office and automotive products, and investment and real estate holding companies.

Klaris, Thomson & Schroeder, Inc. is also pleased to announce the addition of Mr. Alan M. Gochman, CPA, to our Philadelphia area office.

Mr. Gochman specializes in the valuation of closely held companies and intellectual property in connection with acquisitions; sale; financial, estate or corporate planning; ESOP requirements; and fairness/solvency opinions in various industries.

KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

10/18/00	Presentation—Tampa Bay Estate Planning Council and Florida Institute of Certified Public Accountants, Tampa, FL.—"Valuation Issues in Estate Planning"
10/26/00	Exhibit Booth—Estate Planning Council of Bergen County, Inc., Bergen County N.J.—Estate Planners Day
10/27/00	Presentation—Missouri Bar Association Annual Probate Institute, Clayton, MO.—"Valuation Issues for Estates and Estate Planning"
11/1/00	Presentation—Margolius & Mallios, Washington, D.C.—"Advanced Valuation Issues"
11/1/00	Presentation—Berlin, Ramos & Company, P.A., Rockville, MD.—"Advanced Valuation Issues"
11/1/00	Presentation—Shulman, Rogers, Gandal, Pordy & Ecker, P.A., Rockville, MD.—"Advanced Valuation Issues"

KTS RECENT ENGAGEMENTS

* Valuation of the stock of a very large food manufacturer for gift tax purposes.
* Valuation of a limited liability company specializing in venture capital equity investments in high tech operations.
* Valuation of a military boot manufacturer as of various dates from 1981 through 2000 to support gifts of minority interest common stock made on these dates.
* Valuation of undivided interest in farm land for estate tax purposes.
* Valuation update of a large milling company for ESOP purposes.
* Valuation of a company owning a television station and a radio station in the Midwest for estate tax purposes.
* Valuation of minority interest shares of a bank for estate tax purposes.

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is a full service valuation and consulting company specializing in business valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or a free valuation seminar for your firm or professional group, please e-mail your request to info@ktsvaluation.com.

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Valuation Issues

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Quarterly Quote:

"The beginning of knowledge is the discovery of something we do not understand." - Frank Herbert