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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. **2004-2**

SPECIAL ISSUE...

- Court Case Review–McCord v. IRS
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UNITED STATES TAX COURT CASE SUMMARY
120 T.C. No. 13
Charles T. McCord, Jr. and Mary S. McCord v. Commissioner of Internal Revenue
Judge Halpern

John A. Thomson, ASA, MAI

The above mentioned case centers around gift tax consequences of petitioners' assignments to several charitable and non-charitable donees of interests in a family limited partnership.

McCord Interests, Ltd. L.L.P. ("MIL" or the "Partnership") is a Texas limited partnership formed on June 30, 1995. The parents were both Class A and Class B partners and their children (4 sons, of which all are adults) were Class B partners and the general partners. The assets of the partnership consisted of stocks and bonds (66.1 percent), real estate partnership interests (29.4 percent), real estate owned directly (3.3 percent), and oil and gas interests (1.2 percent). The total net asset value ("NAV") was $17,673,760. The valuation date was January 12, 1996. The issues were as follows:

1) Whether the gifts were assignee interests or limited partnership interests.

2) The fair market value of the gifts (each gift being 41.167 percent with a date of value of January 12, 1996).

3) The fair market value of the aggregate charitable contribution.

4) Whether the taxable gifts for 1996 are determined without reference to the contingent estate tax liability that the children assumed.

The focus of our review and comments pertain to items #1 and #2.

Assignee or L.P. Interest

Relative to item #1, the court ruled that the gifts were assignee interests. They cited the Kerr Case which also involved the same law firm, (KTS was also the IRS expert in Kerr).

In the Kerr case, the taxpayer argued that the gifts were assignee interests. The court ruled that they were limited partnership interests. Essentially, in the Kerr Case, the taxpayer and their attorneys did not handle the assignment by the book. However, as stated in the Kerr case, the difference in the discount applicable to the limited partnership interest, as opposed to the assignee interest, was only 3 percentage points; meaning the overall discount applicable to an assignee interest (all else equal) would be approximately 3.0 percentage points higher than a limited partnership interest. In the subject case, the court ruled that the overall discount applicable to the 41.167 percent assignee interest was 32.0 percent, which implied that the discount would have been (could have been) 29.0 percent, if it were a limited partnership interest.

Fair Market Value of the Gifts

Relative to item #2, the valuation issue, the taxpayer's expert, William Frazier of Howard Frazier Barker Elliott, Inc. ("HFBE"), concluded a 22 percent minority discount and a 35 percent marketability discount (an overall discount of 49.3 percent) for a 1 percent assignee interest.[1]

The IRS's expert, Dr. Bajaj of LEC, LLC, concluded a 8.34 percent minority interest discount and a 7 percent marketability discount (an overall discount of 14.8 percent) for a 1 percent assignee interest.

The court was not happy with either expert. The following quotes from the court are essential reading.

1) Relative to the lack of control (minority discount) discount:

a) "For the reasons discussed below, we find neither expert's arguments convincing on that point."

b) "Because we are unpersuaded by the respective arguments of Mr. Frazier and Dr. Bajaj for a higher than average or lower than average minority interest discount factor for MIL's bond portfolio, we utilize the average discount of the sample funds under consideration."

2) Relative to the lack of marketability discount:

a) "In light of those numerous defects, we give little weight to Mr. Frazier's restricted stock analysis."

b) "Dr. Bajaj has indeed been helpful in focusing our attention (and Mr. Frazier's attention) on the distinction between illiquidity and other factors (e.g., assessment and monitoring costs) that contribute to private placement discounts. However, his apparent confusion regarding the nature of the discount for lack of marketability (i.e., whether such discount can be explained purely in terms of illiquidity or whether other factors may be included) is troubling."

c) "Although we reject Dr. Bajaj's

[1] Mr. Frazier asserts that a 41.67 percent assignee interest has no more proportionate value than a 1 percent assignee interest.

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quantification of the appropriate marketability discount in this case, we look to the data from his private placement study."

The court goes on to conclude a 15 percent discount for lack of control- midway between Dr. Bajaj's 8.34 percent and Mr. Frazier's 22 percent. The court goes on to conclude a 20 percent discount for lack of marketability - slightly less than the mid point of Dr. Bajaj's 7.0 percent and Mr. Frazier's 35.0 percent.

The overall discount concluded by the court for a 41.67 percent assignee interest in a partnership, with assets consisting of 66.1 percent marketable securities and 29.4 percent Real Estate partnership interest, was 32.0 percent.

Comments:

1) We note that the experts used a weighted average approach for their lack of control discount.

Therefore, so did the court. We present the court's conclusion below:

Asset Class	Percent of NAV	Percent Discount Factor	Percent Weighted Average
Equities	20.6	10.0	2.06
Bonds	45.5	10.0	4.55
R.E. Partnerships	29.4	23.3	6.85
Real Estate	3.3	40.0	1.32
Oil and Gas	1.2	33.5[2]	0.40
Discount			*15.18*

The lack of control or minority discount applicable to the subject interest is a discount applied to the control value (net asset value in the case of an investment holding company such as the subject partnership). This discount is based on the subject interest's lack of certain features inherent in control value (which may be total or partial depending on the degree of control or lack of control), such as the ability to control distributions or liquidate the partnership or determine which assets to buy or sell or, in general, control the activities of the partnership, subject to its fiduciary responsibility to the rest of the partners. Why would the discount for lack of control, or for the degree of lack of control, for the subject interest in the partnership vary from 10 percent to 40 percent, based solely on asset categories? We believe this logic is seriously flawed.

We believe the differentiation in the overall discount based soley on differences in asset categories more likely belongs in the lack of marketability discount,[3] not the lack of control discount. This is not to say that there couldn't be some differentiation in the lack of control discount based on asset categories and associated risk of each asset categorically by virtue of not being able to control when to buy or sell. However, this would not support a 100 to 400 percent increase in the discount for lack of control (10 percent to 23 or 40 percent[4]). This would imply that if the partnership contained only directly owned real estate, the overall discount would be 52 percent (40 percent lack of control and 20 percent lack of marketability) for the same subject interest.

The court also agreed that the comparative data should be as of the date of value, not 30 days before or after. Lastly, the court stated, "Dr. Bajaj offers a compelling criticism of both the Willamette Studies (by Shannon Pratt) and another series of studies (IPO Studies) undertaken by John D. Emory," "Dr. Bajaj has convinced us to reject Mr. Frazier's opinion as it is unreliable to the extent it is based on the IPO Approach."

In summary, we tend to agree with the court's overall discount[5] of 32 percent as of early 1996 (yes, time can make a difference as the market can and does change). We believe the conclusion is within a reasonable range, albeit at the low end of the range. We point out that this was an assignee interest which most valuation professionals would agree carries, or should carry, a higher discount (all else equal) than a limited partner interest. Therefore, as discussed previously, this assignee interest discount of 32 percent would be approximately equivalent to a 29 percent overall discount for the same limited partnership interest.

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[2]Essentially stipulated to, as the IRS instructed their expert to use these discounts, as used by the taxpayer's expert.

[3] It would or should affect the base discount or starting point before any other factors are considered (see page 23 of the Peracchio decision, as to what Judge Halpern, the same judge as herein, refers to as the starting point).

[4] Over the past several years, one could argue that marketable securities were more risky than Real Estate.

[5] We disagree with the path they took, especially the derivation of the lack of control discount. We would have concluded a somewhat lower discount for lack of control and a higher discount for lack of marketability.

UNITED STATES TAX COURT CASE SUMMARY
T.C. Memo 2003-258
Clarissa W. Lappo v.
Commissioner of Internal Revenue
Judge Thornton

Todd Hollingshead ASA

The above mentioned case centers around gift tax consequences of the petitioner's gifts to her daughter and four grandchildren. On October 20, 1995, the petitioner and her daughter formed the Lappo Family Limited Partnership (the "Partnership"), a Georgia limited partnership. On April 19, 1996, the petitioner transferred a 66.80917 percent limited partnership interest to the daughter as Trustee of the Lappo Generation Trust, and a 0.6680917 percent limited partnership interest to each of the petitioner's four grandchildren. On July 2, 1996, the petitioner transferred her remaining 29.3184632 percent limited partnership interest to her daughter. After the aforementioned gifts, the Partnership's ownership was as follows:

Partner	G.P.	L.P.	Total
Petitioner	1.0%	–	1.0%
Daughter	0.2%	29.3184632%	29.5184632%
Lappo Generation Trust	–	66.8091700%	66.8091700%
Four Grandchildren	–	2.67236680%	2.67236680%
Total	1.2%	98.80000000%	100.00000000%

The issue in the case was the applicable net asset value (NAV), the discounts to apply to the respective interests relative to the assets held by the Partnership, and how it was determined as of each date of gift.

At trial, the taxpayer's expert agreed with the IRS' expert's NAV of the Partnership's portfolio of marketable securities at $1,296,882, as of April 19, 1996 and $1,379,531, as of July 2, 1996. Both agreed on the Partnership's real estate NAV of $1,860,000[1] as of both dates of value. As of April 19, 1996, the Partnership's assets consisted of the following:

Asset	FMV	%
Marketable Securities (primarily municipal bonds)	$1,296,882	41%
Real Estate	$1,860,000	59%
Total	$3,156,882	100%

As of July 2, 1996, the Partnership's assets consisted of the following:

Asset	FMV	%
Marketable Securities (primarily municipal bonds)	$1,379,531	43%
Real Estate	$1,860,000	57%
Total	$3,239,531	100%

The taxpayer's expert applied a 7.5 percent discount for lack of control (minority interest discount) to the Partnership's marketable securities as of both dates of value, a minority interest discount of 35 percent and 30 percent to the Partnership's real estate as of April 19, 1996 and July 2, 1996, respectively, and a discount for lack of marketability (marketability discount) of 35 percent as of both dates of value.

The IRS' expert applied an overall discount (minority interest discount and marketability discount) of 16 percent (8.5 percent lack of control for both the Partnership's marketable securities and real estate, and 8.3 percent marketability discount).

Discount for Lack of Control Applicable to the Partnership's Marketable Securities

At trial, since the petitioner agreed to the IRS' expert's slightly higher net asset value for the marketable securities, the court, out of fairness to the petitioner, concluded at the IRS' expert's 8.5 percent minority interest discount applicable to the Partnership's marketable securities.

Discount for Lack of Control Applicable to the Partnership's Real Estate

Both experts agreed that publicly traded real estate investment trusts (REITs) provided an appropriate starting point for determining the minority interest discount applicable to the Partnership's real estate holdings, but disagreed on the REITs used for comparison. The taypayer's expert started with 400 REITs and narrowed it down to seven. The court was not persuaded by the size of the REIT group or the comparability of the REIT group. The IRS' expert started with 62 REITs as reported by Green Street Advisors, Inc. and narrowed this group to 52. The court believed this sample was sufficiently large.

The taxpayer's expert's seven REITs concluded a median price-to-NAV discount of 29.3 percent and 20.3 percent, as of April 19, 1996 and July 2, 1996, respectively. The taxpayer's expert considered certain factors: the Partnership's strong financial position, smaller real estate holdings, dependence on one primary tenant, and lack of track record of operations. Together, the taxpayer's expert believed that the discounts should be increased. The court concluded that the taxpayer's expert inadequately explained how he derived the NAVs in his price-to-NAV discounts, the volatility of median price-to-NAV discounts between the two dates (approximately 3 months) probably due to a small sample group, and the appropriateness of the upward adjustments (5.7% as of April 19, 1996, and 9.7% as of July 2, 1996).

[1] Based on an appraisal report dated January 24, 1996.

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The IRS' expert's 52 REITs traded at a 4.8 percent median price-to-NAV premium. To be conservative and to account for the fact that partnerships are not obligated to pay large and regular distributions as do REITs, the IRS' expert looked at the 15th percentile, and began with an 0.8 percent discount as of March 25, 1996, and a 1.48 percent premium as of June 25, 1996. The IRS' expert also concluded that the aforementioned discount/premium should be adjusted downward to remove a liquidity premium that is inherent in REITs (i.e., a premium that arises because REIT interests, unlike the assets underlying them, are publicly traded in reasonably liquid markets). Based on a Bajaj study[2], the IRS' expert concluded that liquid assets such as REITs were trading at a premium of 7.5 percent over illiquid assets such as the Partnership interests. When considering the 7.5 percent premium, the IRS' expert's discounts become 8.3 percent (0.8 percent discount less 7.5 percent liquidity premium) and 6.0 percent (1.48 percent premium less 7.5 percent liquidity premium) as of April 19, 1996 and July 2, 1996, respectively. The IRS' expert then compared the aforementioned discounts to his own independent study conclusion of 8.5 percent, and concluded with this discount for both dates of value.

The court agreed with the IRS' expert that, in order to derive a minority interest discount factor from REIT price-to-NAV data, one must account for the liquidity premium inherent in REIT data prices. However, the court did not rely solely on the IRS' expert's academic study. Instead the court wanted to seek common ground between the Bajaj study and similar studies such as the Wruck study[3] and the Hertzel & Smith study.[4] The Wruck study found that the average discount observed in unregistered private placements exceeded the average discount observed in registered private placements by 17.6 percentage points; the Hertzel & Smith study is 13.5 percentage points; and the Bajaj study is 14.09 percentage points. The average of the three studies was 15 percent, which yields a liquidity premium of 17.6 percent [1/(1 - .15)].

Using a 17.6 percent liquidity premium versus the IRS' expert's 7.5 percent liquidity premium, the IRS' expert's minority interest discounts applicable to the Partnership's real estate holdings calculates to 18.4 percent (0.8 percent discount less 17.6 percent liquidity premium) as of April 19, 1996 and 16.12 percent (1.48 percent premium less 17.6 percent liquidity premium) as of July 2, 1996.

Overall Discount for Lack of Control Applicable to the Partnership's Assets

The court concluded an 8.5 percent minority interest discount applicable to the marketable securities and a 19.0 percent minority interest discount applicable to the real estate. The weighted average minority interest discount, as of April 19, 1996, is as follows:

Asset Class	% of NAV	% Disc. Factor	% Wtd. Avg.
Marketable Securities	41%	8.5%	3.49%
Real Estate	59%	19.0%	11.21%
Total Weighted Average			14.70%

The weighted average minority interest discount, as of April 19, 1996, is as follows:

Asset Class	% of NAV	% Disc. Factor	% Wtd. Avg.
Marketable Securities	43%	8.5%	3.66%
Real Estate	57%	19.0%	10.83%
Total Weighted Average			14.49%

The court concluded an overall minority interest discount of 15 percent.

Discount for Lack of Marketability (Marketability Discount)

The taxpayer's expert concluded a 35 percent marketability discount, which the court did not give any credence. The taxpayer's expert looked at 197 private transactions from the Management Planning study and narrowed the field down to 39 transactions in unregistered (restricted) stock, which reported a 29.3 percent median discount. However, 13 of the companies were high-tech with greater risk, and when removed from the group the median discount decreased to 19.45 percent.

The IRS' expert again relied on the Bajaj study which concluded that the portion of private placement discounts attributable solely to impaired marketability was 7.2 percent. However, the court looked to the raw data of the Bajaj study and the Hertzel & Smith study which showed that the average discount with respect to their respective samples of private placements was 22.21 percent and 20.14 percent, respectively. The court averaged both discounts and concluded 21 percent. The court further made a 3 percent upward adjustment to the marketability discount based on previously cited empirical studies and concluded a 24 percent discount.

The overall discount was concluded at 35.4 percent (15 percent minority interest discount and 24 percent marketability discount).

Comments:

1)We ask why the type of asset would have that much impact on the minority interest discount relative to a minority interest in a

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[2] Bajaj et.al., "Firm Value and Marketability Discounts," 27 J. Corp. L. 89, 98 (2001).

[3] Wruck, "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings," 23 J. Fin. Econ. 3 (1989).

[4] Hertzel & Smith, "Market Discounts and Shareholder Gains for Placing Equity Privately," 48 J. Fin. 459 (1993).

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(Cont.)

Limited Partnership. The minority interest discount is a discount for lack of control or the degree of lack of control. We understand how the size of the interest can affect the minority interest discount. Theoretically, all else equal, a much larger interest will have more influence on control than a much smaller interest. However, why should the type of asset have such a significant affect on lack of control? We believe the difference in the overall discount based on the assets owned by the partnership should be considered more in the lack of marketability discount, not the lack of control discount. It would seem intuitive that the lack of control may have more significance for marketable securities than for real estate due to issues of volatility but the court cases with the tiered discounts appear to show just the opposite.

2)With regard to the real estate, we agree that an appraiser should look to REITs. We also agree that there is a liquidity premium inherent in REITs. However, an appraiser should not focus solely on the 17.6 percent liquidity premium concluded in this case, but be aware that there is a liquidity premium inherent in REITs. That said, an appraiser should also look to closed-end specialized equity funds, which primarily hold interests in real estate holding entities. This is another source, which would be a good sanity check and could give more validity to a minority interest discount determination.

3)We believe that the marketability discount (24 percent) could be on the conservative side considering the Partnership's asset mix. Marketable securities are relatively liquid and represented 41 to 43 percent, while the real estate (less liquid) represented 59 to 57 percent. Marketable securities warrant a lower marketability discount than real estate holdings. The SEC Institutional Investor Study reported a 26.4% marketability discount at which transactions in restricted stock (letter stock) took place compared to the prices of identical but unrestricted stock on the open market. Real estate would warrant even a higher marketability discount.

UNITED STATES TAX COURT CASE SUMMARY
T.C. Memo 2003-280
Peter S. Peracchio v.
Commissioner of Internal Revenue
Judge Halpern

John A. Thomson, ASA, MAI

The case involves the transfer of two Limited Partner ("L.P.") interests (a 45.47 percent L.P. interest and a 53.48 percent L.P. interest). The 45.47 percent interest was transferred to a family trust for no consideration, whereas the 53.48 percent interest was transferred to the family trust in exchange for a promissory note ($646,764). The net asset value ("NAV") was $2,010,370, consisting of cash and marketable securities. A profile of the partnership assets appears below:

Asset Type	FMV	%
Cash & Money Market Funds	$ 883,622	44.0
U.S. Government Bond Funds	$ 7,988	0.4
State & Local Bonds	$ 41,750	2.1
National Municipal Bond Funds	$ 101,145	5.0
Domestic Equities	$ 877,179	43.6
Foreign Equities	$ 98,686	4.9
	$2,010,370	100.0

The issue in the case was the applicable discount to apply to the respective interests and also to how it was determined.

The taxpayer expert applied an overall discount (including both lack of control and lack of marketability) of 40.0 percent[1] (7.7 percent lack of control and 35 percent lack of marketability). The IRS's expert applied an overall discount of 18.74 percent (4.4 percent lack of control and 15 percent lack of marketabilty).

Both the taxpayer's expert and the IRS expert used closed end investment funds as their bases for the lack of control discount. Then, they divided the assets of the partnership into six basic categories: cash and money market funds (44.0 percent), U.S. Government bond funds (0.4 percent), state and local bonds (2.1 percent), National Municipal bond funds (5.0 percent), domestic equities (43.6 percent), and foreign equities (4.9 percent).

Both experts allocated different discounts for lack of control to each category of cash and marketable securities and used a weighted average to conclude their overall lack of control discount. The court concluded their discount as follows:

Asset Type	Percent of NAV	Percent Discount Factor	Percent Weighted Average
Cash & Money Market Funds	44.0	2.0	0.88
U.S. Governmental Funds	0.4	6.9	0.03
State and Local Bonds	2.1	3.5	0.07
National Municipal Bond Funds	5.0	3.4	0.17
Domestic Equities	43.6	9.6	4.19
Foreign Equities	4.9	13.8	0.68
Discount			*6.02*

[1] A second expert for the taxpayer concluded a 43 percent discount (5 percent lack of control and 40 percent lack of marketability). However, the court did look upon this expert in a favorable manner.

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Regarding the marketability discount, the court was unimpressed with all of the experts. "Because we are unpersuaded by either expert's determination of the appropriate benchmark (starting point), we give little weight to their respective analysis."

The IRS expert opined to a 15.0 percent lack of marketability discount and the taxpayers two experts opined to 35 percent and 40 percent[2] respectively. The court concluded 25 percent which was (again resorting to the use of higher mathematics) the midpoint between lackluster testimony on both sides, (15 percent plus 35 percent divided by 2).

The court's overall discount conclusion was 29.5 percent (6 percent lack of control and 25 percent lack of marketability applied sequentially).

Comment:

1.) We note that the lack of control discount concluded by the IRS's expert was 4.4 percent and the taxpayer's expert concluded 7.7 percent (one of the taxpayer's experts concluded 5 percent, but the judge gave no weight to his lack of analysis). The court concluded 6.0 percent based on the use of higher mathematics, it would appear the court concluded within whispering distance of the midpoint.

2.) The court stated (based on the data it had to work with) that the lack of control discount for marketable securities (domestic equities) was 4.8 times greater than the cash and money market funds[3] (9.6 divided by 2.0).

3.) We ask why the type of asset would have that much impact[4] on the discount for lack of control relative to a minority interest in a Limited Partnership. Maybe there should have been a discussion on what lack of control means. We strongly agree that the type of asset will or should make a difference in the lack of marketability discount, but we are not convinced that the disparity should be that extreme for the lack of control discount based soley on asset type. We argued this issue in the Thompson case before Judge Jacobs. Unfortunately, for valuation clarity, the IRS won the case on a 2036 issue and valuation was not discussed in the decision.

4.) A wise tax court Judge once said, "poor facts (poor data and testimony) makes for poor decisions."

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[2]Mr. Stryker's (from BDO Seidman) lack of analyzation on the marketability or maybe overall discount and his lack of control discount basically put the court in the position of giving no weight to his report.

[3] There was no bench mark presented for the discount applied to the cash and money market funds merely "Judgement."

[4] We do believe that there can be some moderate differences based on the asset composition.

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Valuation Issues
2004-2

Quarterly Quote:

"Success is a journey not a destination."
- Ben Sweetland